Nos. 89-1452 and 89-1453

In The

Supreme Court of the United States

October Term, 1990

Mobil Oil Exploration & Producing Southeast, Inc., *et al.*,
Petitioners,

v.

United Distribution Companies, *et al.*,
Respondents.

Federal Energy Regulatory Commission,
Petitioner,

v.

United Distribution Companies, *et al.*,
Respondents.

On Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit

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JOINT APPENDIX

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Dated: August 9, 1990

PETITIONS FOR CERTIORARI FILED MARCH 14 AND 15, 1990
CERTIORARI GRANTED JUNE 4, 1990

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IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 86-4940

MOBIL OIL EXPLORATION AND PRODUCING SOUTHEAST, INC., *et al.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

RELEVANT DOCKET ENTRIES

Date	Filings—Proceedings
1/27/87	Order of the Court on Venue (in 5th Cir.). (CC, HT, PEH).
4/2/87	Order CLARIFYING venue and DENYING motion to transfer. (CC, HT, PEH).
4/7/88	Minute Entry: Pre Hearing Conference held before J. Johnson, Aus., TX.
12/20/88	Order GRANTING motion of the Joint Opponents for expedited rescheduling of oral argument in the referenced case to the extent that this case will be rescheduled on the next occasion when Federal Energy Regulatory Commission cases are set. (CC).
8/9/89	ORDER: This case was argued to the Court on 4/17/89. Even so, the opinion of the Court has not been finalized as of this date. Therefore, both the motion for leave to intervene out of time of City Utilities of Springfield, Missouri, and the motion of Williams Natural Gas Company for stay, must be, and are, CARRIED WITH THE CASE. It is so ordered. (CC, JRB, SDJ).

Date	Filings—Proceedings
9/15/89	Decision of the court.
9/18/89	Order DENYING motion of Williams Natural Gas Company for a stay pending review. (CC, JRB, SDJ).
9/28/89	ORDER: Judge Brown's dissenting opinion in the above captioned case was issued on 9/26/89. Notwithstanding the previous majority opinion or requests for extensions of time to file petitions for rehearing, the Court has directed that the time for filing all petitions for rehearing shall run from the date of the dissent of Judge Brown, that is, 9/26/89. Therefore, all requests or petitions for rehearing will be due for filing with this Court on or before 10/10/89. (CC, JRB, SDJ).
10/16/89	Letter from Clerk's Office advising that a response to the Petitions for Rehearing and to the Petitions for Rehearing *En Banc* is appropriate.
1/9/90	Order DENYING motions of Indicated Producers and the FERC for stay of mandate pending application for writ of certiorari; further DENYING motion of Indicated Producers Intervenors to strike and for sanctions. (CC, JRB, SDJ).
1/9/90	Order DENYING alternative motion of the Indicated Producers for a 3 day stay of the issuance of the mandate in order to permit the filing of a stay application to the U.S.S.C. and for the continuation of a stay of the mandate pending the Supreme Court's action on such motion. (CC, JRB, SDJ).
1/10/90	Order of S.C. staying issuance of the Court's mandate pending receipt of responses to the application and further order of the under signed or of the Court.

FEDERAL ENERGY REGULATORY COMMISSION

RELEVANT DOCKET ENTRIES

Accession No.	Date	Proceedings
8511250082	11/18/85	Submits DOE proposed rule eliminating old gas vintaging and establishing incentive prices for certain categories of gas.
8512040673	12/2/85	Comments of the Department of Justice on Proposed Rulemaking.
8601080674	12/20/85	Notice of procedural schedule re. ceiling prices; old gas pricing structure.
8601230272	1/17/86	Petition of Associated Gas Distributors for order adopting additional procedures re ceiling prices.
8602130368	2/10/86	Fwds. petition of United Distribution Co. for summary dismissal of rulemaking proceedings.
	4/10-11/86	Public Hearing.
8606270049	6/6/86	Order #451, final rule re. ceiling prices; old gas pricing structure.
8607110160	7/3/86	Application of KN Energy, Inc. for rehearing of Order #451 and petition of KN Energy, Inc. et al. re ceiling prices; old gas price et al.
	7/2-8/86	Petitions for rehearing filed.
8607250417	7/18/86	Order staying the effectiveness of Order 451 re. ceiling prices; old gas pricing structure under RM 86-3-000.

Accession No.	Date	Proceedings
8607310629	7/28/86	Order denying petitions for stay of Order 451 re. ceiling prices; old gas pricing under RM 86-3.
8608070391	8/4/86	Order granting rehearing for further consideration re. ceiling prices; old gas pricing structure.
8612090139	12/5/86	Petition for stay of effective date re Good Faith Negotiation procedures for Ceiling Prices in RM86-3.
8612170177	12/15/86	Order 451-A granting rehearing in part/denying rehearing in part/clarifying final rule establishing new ceiling prices.
	12/16/86-1/12/87	Petitions for review filed.
8702190297	2/11/87	Order of U.S. Court of Appeals, D.C. Circuit dismissing petition for review re. United Distribution Companies. Docket 86-1665, 86-1672, 86-1673, 86-1660, 86-1664.
8702190287	2/11/87	Order of U.S. Court of Appeals, D.C. Circuit granting motions and dismissing case #'s 86-1667 and 86-1668.
8706160447	6/8/87	Cert. of record in lieu of record in 5th Circuit Court of Appeals re. Mobil Oil E&P Southeast vs. FERC. Docket 86-4940.
8711020276	10/22/87	Petition for review of FERC order No. 451-B issued 870603 and order No. 451-C issued 870805 re. Arkla Energy vs. FERC.

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

51 F.R. 22168 (June 18, 1986)

18 CFR Parts 154, 157, 270, 271 and 284

[Docket No. RM86-3-000; Order No. 451]

Ceiling Prices; Old Gas Pricing Structure

Issued June 6, 1986

AGENCY: Federal Energy Regulatory Commission, DOE.

ACTION: Final rule.

SUMMARY: On November 18, 1985, the Department of Energy (DOE) issued a Notice of Proposed Rulemaking (NOPR) under section 403 of the Department of Energy Organization Act, 42 U.S.C. § 7173 (1982), for action by the Commission. 50 F.R. 48540 (Nov. 25, 1985). DOE proposed that the Commission (1) exercise its authority under sections 104(b)(2) and 106(c) of the Natural Gas Policy Act of 1978 (NGPA), to eliminate vintage-based pricing of old gas through the establishment of a uniform ceiling price equal to the highest current ceiling price for old gas, which is that for the post-1974 vintage and (2) establish incentive prices for certain categories of old gas under section 107 of the NGPA.

The Commission is amending its regulations to adopt DOE's proposed ceiling price and thereby eliminate vintaging. Producers may collect the new ceiling price only to the extent permitted by their contracts. Indefinite price escalation clauses in existing contracts provide the necessary authority; however, the producer must comply with a "good faith negotiation rule" before collecting a higher price under an existing contract. The Commission has

modified the good faith negotiation rule proposed by DOE in order to increase the rights of purchasers in renegotiating prices under old gas contracts. Accordingly, if the producer seeks renegotiation to increase the price of old gas, the purchaser may seek renegotiation to decrease the price of certain higher-priced gas purchased from the same producer.

The Commission is providing blanket sales certificates to producers and blanket transportation certificates to interstate pipelines to facilitate marketing any gas for which the producer and pipeline cannot agree on price under the good faith negotiation rule.

The Commission is deferring action on that part of the DOE proposal concerning new incentive prices under section 107 of the NGPA.

EFFECTIVE DATE: July 18, 1986.

FOR FURTHER INFORMATION CONTACT:

Christopher J. Warner, (202) 357-8440; Howard B. Schneider, (202) 357-8511; James J. Hoecker, (202) 357-8530; Richard Howe, Jr., (202) 357-8306; Darrell Blakeway, (202) 357-8213; Office of the General Counsel, Federal Energy Regulatory Commission, 825 North Capitol Street, NE., Washington, DC 20426.

SUPPLEMENTARY INFORMATION:

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I. Introduction

The Federal Energy Regulatory Commission (Commission) is adopting a final rule that revises the maximum lawful price for natural gas priced under sections 104 and 106 of the Natural Gas Policy Act of 1978 (NGPA)[1] and that establishes procedures designed to make the price for those categories of natural gas responsive to actual conditions in the competitive wellhead markets for gas. The Commission's final rule establishes a single alternative ceiling price for those categories of so-called "old gas" that were committed or dedicated to interstate commerce before the enactment of the NGPA, or subject to an intrastate rollover contract under the NGPA. The rule thereby provides for elimination of the various ceiling prices for different "vintages" of old gas previously set according to when the gas reserves were produced.

This rulemaking proceeding was initiated by the Secretary of Energy under section 403 of the Department of Energy Organization Act.[2] The Commission's objectives in adopting a final rule, like the Secretary's initial objectives, are to enable the prices for regulated natural gas to more closely reflect its value in the market, to provide more accurate price signals to consumers of natural gas, to ensure the efficient and rational development of the gas supplies that will be needed in future years, and to prevent the loss of substantial portions of the nation's supply of least-cost natural gas.

Because the current regulatory structure prices the commodity at drastically differing levels, and without regard to the actual cost of replacing dwindling reserves of gas or the costs of competing alternative fuels, the Commission is eliminating these existing market distortions, to the extent permitted under its statutory charter. It is taking action under both the NGPA and the Natural

[1] 15 U.S.C. 3314 and 3316 (1982).

[2] 42 U.S.C. 4273 (1982).

Gas Act[3] so that consumers are assured of long-term access to reasonably-priced supplies of natural gas.[4]

II. Background

A. *Procedural History*

This rulemaking proceeding began with a notice of proposed rulemaking issued by the Secretary of the Department of Energy, under section 403 of the Department of Energy Organization Act.[5] The Secretary proposed final action by the Commission by June 1, 1986.

The Secretary's proposal provided the Commission with the flexibility to establish the public hearing and comment procedures. Accordingly, the Commission established a procedural schedule for initial public comment.[6] This procedural notice identified several issues to which it directed commenters' attention. The Commission requested comment on the scope of Commission authority to implement the Secretary's proposal, including the elements of the just and reasonable rate standard that apply to old gas prices, the operation of indefinite price escalator clauses in existing contracts for old gas, the relationship of the Secretary's proposal to the Commission's block billing proposal,[7] and the likely response of the market in developing or delivering old gas supplies. The Commision later asked for reply comments.[8] On April 10 and 11, 1986, the Commission also held a two-day public conference. There were approximately 45 participants in the public conference representing consumers, state utility commissions, producers, pipelines, local distribution companies, end-users, and other interested members of the public.

The record in this proceeding consists of approximately 113 initial and 37 reply comments, including numerous studies, and 584 pages of hearing transcript. The Commission is acting in compliance with the Secretary's schedule. This rule will become effective 30 days after publication in the Federal Register.

B. *The Secretary's Proposal*

The Secretary's proposal to revise old gas[9] prices is intended as a companion to the Commission's Order 436,

[3] 15 U.S.C. 717-717w (1982).

[4] *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi*, 474 U.S. ——, 88 L. Ed. 2d 732, 745, slip op. at 14 (January 22, 1986) ("The change in regulatory perspective embodied in the NGPA rested in significant part on the belief that direct federal price control exacerbated supply and demand problems by preventing the market from making long-term adjustments.").

[5] 50 FR 48540 (November 25, 1985). Section 403 provides in pertinent part:

Sec. 403. (a) The Secretary and the Commission are authorized to propose rules, regulations, and statements of policy of general applicability with respect to any function within the jurisdiction of the Commission under section 402 of this Act.

(b) The Commission shall have exclusive jurisdiction with respect to any proposal made under subsection (a), and shall consider and take final action on any proposal made by the Secretary under such subsection in an expeditious manner in accordance with such reasonable time limits as may be set by the Secretary for the completion of action by the Commission on any such proposal.

[6] 50 FR 52935 (December 27, 1985).

[7] As a means of addressing many of the same gas market problems highlighted by the Secretary, the Commission had previously proposed a rule that would require categories of gas purchased by interstate pipelines to be billed in ways that eliminate the distortions caused by "rolled-in" pricing of gas by pipelines. 50 FR 24180 (June 7, 1985) (Docket No. RM85-1-000; Part D; 50 FR 42372 (Oct. 18, 1985).

[8] 51 FR 7583 (March 5, 1986).

[9] "Old gas" or "old flowing gas" as used in this rule is generally natural gas that was committed or dedicated to interstate commerce on the day before enactment of the NGPA, as well as intrastate flowing gas subject to the price ceilings for intrastate rollover con-

enabling all segments of the gas industry to participate in an open and competitive gas market with non-discriminatory access to self-implementing and blanket transportation and flexible transportation rate structures.[10] As the Commission recognized in Order No. 436, gas should be priced to bring about efficiency in both its production and its consumption and to reflect the resource cost of bringing the commodity to market. In other words, prices should ensure that the consumer's willingness to pay for a unit of gas corresponds to the cost of producing a unit of gas at that time.[11] Prices should also allow the market to clear; that is, gas supplied should equal gas demanded. In addition, natural gas must be priced to avoid wasteful depletion of such a non-renewable resource. In sum, prices should respond to current conditions and decisions and not to conditions, costs, and decisions in the past.[12] The Commission and the Secretary agree that certain gas ceiling prices do not now reflect these pricing standards. The Secretary's proposal to resolve current old gas pricing problems is generally adopted by the Commission, with revisions discussed below, in furtherance of these mutual objectives. In his November 18, 1985, notice of proposed rulemaking (hereinafter, DOE proposal), the Secretary proposes that the Commission:

tracts under section 106(b). These gas supplies are priced according to NGPA sections 104 and 106, which permit the Commission to prescribe by rule or order a price higher than the otherwise applicable maximum lawful price, provided it is "just and reasonable within the meaning of the Natural Gas Act." "New gas" as used in this rule is gas priced under NGPA sections 102, 103, 105, and 108. "High-cost gas" is gas incentively priced under NGPA section 107.

[10] Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 FR 42408 (Oct. 18, 1985); Order No. 436-A, 50 FR 52217 (Dec. 23, 1985).

[11] *See, e.g.*, Kahn, The Economics of Regulation: Principles and Institutions, I, 65-70.

[12] *See, e.g.*, Order No. 436, 50 FR, at 42373-74, 42415-21 (October 18, 1985).

(1) Establish a single new just and reasonable ceiling price, equivalent to the current price for post-1974 old gas,[13] for all old "flowing" gas subject to NGPA sections 104 and 106(a), including elimination of the current system of pricing such old gas by the vintage of its production[14];

(2) Establish an incentive ceiling price under NGPA section 107, equivalent to 60 percent of the section 102 price in 1986 and escalated in annual increments to the full section 102 price in 1991, for certain old gas for which recovery involves "extraordinary risks or costs,"[15] namely production enhancement projects,[16] new infill wells, and existing low production or "marginal" wells[17];

[13] Under § 271.101, Table II, of the Commission's regulations, the price of post-1974 gas subject to sections 104 and 106 was $2.525 per MMBtu for deliveries during November 1985. The June 1986 price for that vintage of gas, adjusted for inflation, is $2.57 per MMBtu.

[14] Under "vintaging," first adopted by the Federal Power Commission in the *Permian Basin Rate Proceedings* ("Permian") (34 FPC 159, 185-88 (1965), aff'd 390 U.S. 747 (1968)), separate prices were set for old and new gas, with new gas prices designed to reflect current costs of new supply. As used in this final rule, "vintaging" refers to both the separate prices set by the Commission for various categories of old, flowing gas in area and national rate cases under its NGA jurisdiction prior to enactment of the NGPA, and to the NGPA's continuation of these separate prices through separate maximum ceiling prices for those categories under the NGPA.

[15] 15 U.S.C. 3317(b) and (c) (1982).

[16] The current production enhancement maximum lawful price is the lesser of the NGPA section 109 price or the renegotiated price agreed to by the parties under § 271.704(b)(3) of the Commission's regulations.

[17] The DOE proposal would create two new incentive price categories. "New infill wells" are defined by DOE in the same way as new, onshore production wells under NGPA section 103, except that outer continental shelf (OCS) wells would be included and the qualifying date would be January 1, 1986. Gas produced from such

(3) Provide for good faith renegotiation of contracts between producers and pipeline purchasers to prevent the higher price for old gas from being automatically collected under existing contracts, and provide for procedures that allow producers that are not offered a higher price for old gas supplies to conditionally abandon sales service to the existing purchaser and to sell the gas to a new purchaser for no less than a two-year term.[18]

The Secretary cites several conditions that support his proposal. He contends that vintaging distorts gas price signals in the natural gas market, raises consumer prices above market clearing levels, inhibits efficient production of least-cost supplies, and will, unless modified, result in the permanent loss of some 11 trillion cubic feet of natural gas. According to DOE, a primary problem is that overall prices for gas have not responded to competitive market conditions, despite the current surplus of available gas supplies. This failure, says DOE, is caused by the "cushion" provided by current old gas ceiling prices,

wells would be eligible for a price up to the new ceiling and would be subject to the good faith negotiation rule. DOE also proposes an incentive price category for "marginal wells", defined like stripper wells under NGPA section 108, except that 120 Mcf per day would be the production limit instead of 60 Mcf per day.

[18] Under the DOE proposal, if the purchaser nominates the ceiling price, sale of the gas would continue at the ceiling price. If the purchaser nominates a lower price, the seller may accept the nominated price or refuse it, in which case sales would continue at the existing price, but the seller would have the right at any time to sell the gas to another purchaser at a higher price if the sale was for a term of at least two years. In that event, the producer would automatically be released from any further obligation in law or contract to the existing purchaser upon 30 days notice. If a purchaser refused to nominate a price within 60 days after being requested to do so, the seller would be free to sell to another purchaser subject only to the new ceiling price and would be released from all obligation to the purchaser upon 30 days notice. In either case, abandonment would be deemed granted generically and the producer would not be required to file an abandonment application with the Commission.

which are below market-clearing levels and are "rolled in" with higher-cost gas supplies to produce a deceptively low weighted average cost of gas ("WACOG"). As a result, consumers have not realized the full benefits of wellhead market competition mandated by the NGPA. In its *Second DOE Section 123 Report*, DOE concluded:

> Price controls create an incentive for pipeline companies to purchase a mix of low-cost and high-cost gas. Consumers pay an average of these prices. Price controls on low-cost, old gas allow a high-cost domestic and imported gas to receive prices above the average price. The prices paid for high-cost gas will exceed the average price by an amount that results in the average price matching the price that consumers are willing to pay for natural gas. The price consumers are willing to pay for gas is equal to the cost of not using gas or the price of alternative fuels. Thus, the major beneficiaries of price controls on old gas are high-cost domestic producers and gas importers, *not* consumers.[19]

Vintage pricing fails to assign a reasonable share of the replacement cost or marginal cost of new supplies to purchasers of old gas, and old gas ceiling prices must therefore be corrected to take into account current competition in natural gas markets, according to the DOE proposal. In addition, existing incentive prices for high-cost gas are largely unavailable for enhanced recovery of low-cost gas supplies and, according to the Secretary, will result in the loss of over 20 trillion cubic feet of reserves. The DOE proposal is designed to eliminate market distortion, promote efficient production of gas reserves, and result in lower average gas prices as well as reduced dependence on foreign energy supplies. The Secretary

[19] U.S. Department of Energy, *Increasing Competition in the Natural Gas Market: Second report required by Section 123 of the Natural Gas Policy Act of 1978*, p. 137 (1985).

claims that it will provide net benefits to the American economy of over $25 billion over the next 10 years.

The DOE proposal would enable first sellers to claim the proposed new ceiling price only if authorized by contract. Approximately 90 percent of old gas is sold under contracts incorporating sufficient authorization in the form of indefinite price escalation clauses such as area rate clauses.[20] Most old gas producers would therefore be entitled to the new ceiling price, under the DOE proposal, only to the extent they negotiate a new or amended contract price, or find a new purchaser under the DOE "good faith negotiation" proposal. Under the DOE proposal, the existing vintage categories and applicable ceiling prices would remain in effect for sales made under contracts lacking the necessary authority.

C. *The Commission's Authority under the NGA and the NGPA*

1. Just and Reasonable Old Gas Prices

With the enactment of the NGPA, Congress comprehensively changed the method of pricing natural gas produced in the United States. Congress provided for partial phased deregulation of prices at the wellhead in recognition of the competitive nature of the wellhead market and the commodity nature of natural gas. Gas that was not contractully committed or dedicated to interstate commerce before enactment of the NGPA has been removed from the Commission's NGA jurisdiction. However, Congress retained controls over sales for resale of gas commenced before the date of enactment of the NGPA in interstate commerce. Under the NGA, gas that is dedicated to interstate commerce cannot be abandoned without the Commission's approval.

[20] Interstate Natural Gas Association of America, Initial Comments, p. 24. *See also,* Pennzoil Co. v. FERC, 645 F.2d 360 (5th Cir. 1981).

Title I of the NGPA sets prices for all interstate and intrastate "first sales" of natural gas. The ceiling prices established by sections 102 through 109 of Title I, adjusted for inflation, are the maximum lawful prices (MLPs) allowed for such gas at the wellhead. Section 121 removes ceiling prices for certain gas under sections 102, 103, 105 and 107. Sections 102 and 103 established the MLP for certain categories of new gas, section 105 established the MLP for certain intrastate gas, section 107 established the MLP for stripper well gas, and section 109 established the MLP for any category of gas which was not covered by the MLP prescribed in any other section.

This rule deals specifically with two categories still under the Commission's pricing jurisdiction. Section 104 established the MLP for gas which was committed or dedicated to interstate commerce on November 8, 1978, and for which a just and reasonable rate under the NGA was in effect on that date. In all, the Congress incorporated into the NGPA some 16 different categories of prices for section 104 gas established according to vintage. These various prices had been established by the Commission in area and national rate proceedings.[21] The NGPA incorporated these rates by reference, with monthly adjustments for inflation.

The second category of gas affected by the rule is subject to section 106 of the NGPA, which establishes an

[21] Area Rate Proceeding—Opinion Nos. 598 and 598-A, Southern Louisiana Area II, 46 FPC 86 and 633, respectively (1971); Opinion No. 586, Hugoton-Anadarko Area, 44 FPC 71 (1970); Opinion Nos. 595 and 595-A, Texas Gulf Coast Area, 45 FPC 674, 714 and 46 FPC 827, respectively (1971); Order Nos. 411, 411-A, and 411-B, Appalachian and Illinois Basin Areas, 44 FPC 1112, 1334, and 1487, respectively (1970); Opinion Nos. 468 and 468-A, Permian I, 34 FPC 159 and 1068, respectively (1965), and Opinion Nos. 662 and 662-A, Permian II; National Rate Proceedings—50 FPC 390 and 932 (1973); Opinion No. 699-H, 52 FPC 1604 (1974), Opinion No. 749, 54 FPC 3090 (1975), Opinion No. 770, 56 FPC 509 (1976), Opinion No. 770-A, 56 FPC 2698 (1976).

MLP for sales of gas subject to interstate and intrastate "rollover contracts," meaning any contracts that replace expired contracts which were in effect on the date of NGPA enactment.[22]

Sections 104, 106, and 109 [23] give the Commission the authority to prescribe, by rule or order, for any first sale of gas subject to the MLP of sections 104, 106, and 109, a price higher than the MLP otherwise applicable to such gas, *if* the price is just and reasonable within the meaning of the NGA.

Section 4 of the NGA requires that any rates for sales of natural gas be just and reasonable. This "just and reasonable" standard must guide any Commission exercise of its authority to raise the maximum lawful price of old gas. The Commission has been setting just and reasonable rates for nearly fifty years under the NGA, and there is substantial judicial guidance in establishing rates that comply with the just and reasonable mandate of NGPA sections 104 and 106.

Rates are just and reasonable if they are within a "zone of reasonableness," [24] meaning that a rate is neither so excessive as to exploit the consumer nor an unconstitutional confiscation of the property of the registered entity, in this case the gas producer. In other words, higher producer rates that do not provide offsetting benefits to the consumer are above the zone of reasonableness. Likewise, rates that do not provide the producer enough revenue to cover its operating costs and attract investment capital are below the zone.

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[22] NGPA section 2(12), 15 U.S.C. 3301 (1982).

[23] This final rule does not affect the price of gas under NGPA section 109, which governs gas committed or dedicated to interstate commerce but for which no just and reasonable rate was in effect on the date the NGPA was enacted. By statute, the MLP for this gas is equal to the highest section 104 price.

[24] FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942).

The courts have described the breadth of Commission discretion in setting just and reasonable rates. The "end result" of a ratemaking proceeding governs whether the rate is just and reasonable,[25] as long as the rates established fall within the zone of reasonableness. The courts have indicated they will affirm rates based on any of several methodologies, ranging from a conventional utility-type ratemaking using the cost of service, to market-based pricing designed to promote certain public interests. In *City of Detroit v. FPC ("Detroit")*[26], the circuit court indicated that it would have approved a rate based on the market price of gas, if the Commission compared the results to a rate based on the conventional cost-of-service, and if the rate increase were no more than necessary to encourage exploration and development, the agency's stated purpose. Moreover, the only basis on which the Court disallowed exclusive reliance on market prices to regulate rates of small producers in its *FPC v. Texaco* ("*Texaco*") decision,[27] was a finding that the Congress, in enacting the NGA, had subjected producers to regulation because the market was not competitive. In 1978, the Congress recognized the competitive nature of natural gas wellhead markets when it adopted Title I of the NGPA.[28]

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[25] FPC v. Hope Natural Gas Co. ("Hope"), 320 U.S. 591 (1944).

[26] 230 F.2d 810, 818-19 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 289 (1956).

[27] 417 U.S. 380 (1974). The Court would have allowed the Commission to regulate small producers indirectly if the Commission had used criteria in addition to the market price to judge the reasonableness of the prices charged.

[28] See Pennzoil Co. *et al. v. FERC*, 645 F.2d 360, 378-89 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982); Permian Basin Area Rate Cases, 390 U.S. 747, at 756-7 (1968) ("Producers of natural gas cannot usefully be classed as public utilities . . . . They are intensely competitive vendors of a wasting commodity they have acquired only by costly and often unrewarded search.")

In sum, courts decision affords the Commission significant latitude in setting just and reasonable rates. Under *Detroit*, the Commission should use the cost-of-service as a starting point. Other cases stress the Supreme Court's statement in *Hope* that the ratemaking method alone does not determine whether a rate is just and reasonable. A variety of methods have met the end result test. For example, the courts approved generic ratemaking in the area and national rate cases that established uniform rates for certain categories of gas. In those cases, the FPC attained certain administrative and policy objectives by setting rates for a particular category of gas that did not necessarily coincide with actual costs to the individual to produce that gas. In reviewing orders that included a minimum rate higher than the price in many existing contracts, the Fifth Circuit approved rates that exceeded producer costs.[29] Rates for old gas may be based on the cost of replacing reserves, i.e., on the marginal or replacement cost.[30] The FPC even established a new maximum rate for old gas that accounted for replacement cost by using a 1972 test year to determine cost of production from the wells, many of which were drilled up to 40 years earlier at lower absolute cost.[31]

In addition to cost-based methods that diverge from original cost ratemaking, a variety of non-cost-based fac-

[29] Tenneco Oil Co. v. FERC, ("Tenneco") 571 F.2d 834 (5th Cir. 1978), in which the Commission was held to have authority to establish a minimum rate, even though to do so abrogated existing contracts for lower prices. Among other things, the agency believed increasing prices would maximize production from existing wells and redress a bargaining imbalance among the pipelines. *See also*, Permian Basin Area Rate Cases, 390 U.S. 747, 820-21 (1968).

[30] In Shell Oil Co. v. FPC ("Shell"), 520 F.2d 1061 (5th Cir. 1975), the court approved orders establishing rates for "rollover" gas equal to rates for the newest gas. Thus, for gas sold under contracts replacing expiring contracts, the rate had no relation to the actual cost of production. *See also*, Mobil Oil Corp. v. FPC ("Mobil"), 417 U.S. 283, 320 (1974).

[31] Tenneco Oil Co. v. FERC, 571 F.2d 834, 840-42 (5th Cir. 1978).

tors may be used in determining a just and reasonable rate under the NGA. Those factors embody other public interest considerations such as increasing supply, managing demand, influencing industry structure, and achieving price stability.[32]

The FPC adopted the vintaging system in its area rate cases, phased it out under a national rate scheme that allowed old gas under "rollover" contracts to rise to the price of the newest gas, and later reinstated vintaging to mitigate the effects on consumers of dramatic increases in the cost of new gas.[33]

The history of just and reasonable rates under the NGA therefore demonstrates that the Commission has broad discretion to set rates using historical, marginal, or replacement costs and non-cost factors. When the Congress adopted the FPC's vintages in NGPA sections 104 and 106, it incorporated rates that had already departed to various degrees from the original cost of production. Significantly, the Congress expressly gave the Commission further authority to raise even those prices, provided the result would be just and reasonable under the NGA. It is this discretion that the Commission exercises here.

2. Authorization for Abandonment of Service

Another statutory mechanism enables the Commission to oversee a comprehensive regulatory scheme of interstate natural gas service. A sale for resale of natural gas in interstate commerce is subject to the Commis-

[32] *See generally*, *Detroit*, 230 F.2d at 816, *Permian*, 390 U.S. at 796, 815, Southern Louisiana Area Rate Cases ("SoLa I"), 428 F.2d 407, 426-27, 441 (5th Cir. 1970), *cert. denied*, 400 U.S. 950 (1970), *Mobil*, 417 U.S. at 320, *Tenneco*, 571 F.2d at 846, American Public Gas Ass'n v. FPC ("APGA"), 567 F.2d 1016, 1030, 1058 (D.C. Cir. 1977).

[33] *See*, *Permian*, 390 U.S. 747, *SoLa I*, 428 F.2d 407, *Mobil*, 417 U.S. 283, *Shell*, 520 F.2d 1061, *APGA*, 567 F.2d 1016.

sion's "abandonment" authority under NGA section 7. While section 7(c) requires that the Commission grant a certificate of public convenience and necessity prior to such a sale, once gas reserves have been committed to an interstate pipeline, any sales from these reserves cannot be sold to another purchaser without Commission approval under section 7(b). In other words, a producer cannot cease service to an interstate pipeline without a Commission grant of abandonment authority. Abandonment, while typically considered on a case-specific basis, has been generically authorized.[34]

During natural gas shortages in the 1970's, the Commission seldom authorized abandonment of producer sales. However, recently, for example, circumstances have allowed the Commission to further consider its policy on abandonment.[35] Recognizing that the natural gas market has moved from a regional market to a national market, the Commission broadened its abandonment policy to mitigate price distortions that restrained sales of low-priced gas. The Commission sought to provide purchasers with the opportunity to lower their gas costs by displacing high-cost gas or other fuels with purchases of more reasonably-priced gas, a policy of considerable importance to this proceeding. The Commission noted that if a party can demonstrate that abandonment would have beneficial effects on the natural gas market overall, such as increasing competition and thus contributing to a corresponding reduction in prices, and that the benefits of the abandonment outweigh any adverse effects to the purchaser to whom the gas is presently committed by contract, or that purchaser's customers, the Commission will grant abandonment.[36]

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[34] *See, e.g., FPC v. Moss*, 424 U.S. 494, 501 (1975); Order No. 319, 48 FR 34872 (August 1, 1983).

[35] *See, e.g., Felmont Oil Corp. and Essex Offshore, Inc.*, 33 FERC ¶ 61,333 (1985) (Opinion No. 245), *reh'g denied*, 34 FERC ¶ 61,296 (1986) (Opinion No. 245-A).

[36] 33 FERC at 61,657.

In this rule, the Commission grants conditional authority to abandon service if the good faith negotiation procedure fails to produce an agreement between existing sellers and purchasers of old gas under the revised MLP provisions of § 271.402. This conditional authority is provided in order to assure the overall goal of more competitive wellhead pricing and greater access to market-responsive gas under the new ceiling price structure for old gas.

D. The Need For the Final Rule

Over the last ten years, natural gas wellhead and transmission markets have undergone substantial changes in both structure and behavior. In addition, Congress has found that wellhead markets are workably competitive, and has partially deregulated wellhead prices.[37]

During this period, the Commission itself continuously has revised its natural gas regulatory policies, in order to fulfill its obligations under the NGA and NGPA to update its regulations in light of changes in natural gas markets.[38]

On the one hand, the Commission has reviewed and adjusted its regulation of natural gas in response to increased competition in gas markets brought about by the NGPA and changes in world energy prices.

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[37] Transcontinental Gas Pipe Line Corp., 474 U.S. —— ——, 88 L.Ed. 2d 732, 745, *supra*, slip op. at 14, n. 6 ("Congress clearly intended to eliminate the distortive effects that NGA price control had had on supply and demand."); Pennzoil v. FERC, 645 F.2d 360, 378-79 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982).

[38] Permian Basin Area Rate Cases, *supra* at 777 (1968) (". . . ratemaking agencies are not bound to the service of any single regulatory formula; they are permitted, unless their statutory authority otherwise plainly indicates, 'to make the pragmatic adjustments which may be called for by particular circumstances,' F.P.C. v. Natural Gas Pipeline Co., *supra*, at 586.").

On the other hand, during this period, the Commission has not revised its methodology of regulating producer sales of old gas in response to these changes in market conditions. As a result and as discussed in more detail in the Commission's response to comments, *infra*, the existing rate structure for old, flowing gas has created at least three problems for natural gas consumers, pipelines, and producers.

First, the existing rates for most old gas are below the replacement cost of gas reserves. For example, according to the Energy Information Administration, 2.1 Tcf of "old gas," out of a total of 8.4 Tcf of all gas purchased from non-affiliated producers by major interstate pipelines, were priced at or below $2.12 per MMBtu in 1984, as compared to overall average wellhead prices of $2.78 per Mcf, and average new gas prices of $3.65 per Mcf in the same year. Therefore, consumers of gas are neither seeing nor paying the true costs of replacing each unit of old gas with a new unit of reserves. Most producers of old gas are not receiving revenues equivalent to the marginal costs of replacing depleted old gas reserves, and gas reserves are being consumed faster than they are being replaced. Between 1978 and 1984, reserve additions averaged only 90% of consumption. As the comments in this record indicate, in many cases producers are shutting in existing reserves of old gas because they are uneconomic to produce under the artificially low ceiling prices. On the other hand, producers are obtaining higher prices for new and high-cost gas reserves which are frequently more expensive to recover than existing old gas reserves. As of March 1986, the average cost of new and high-cost gas was $3.38 per Mcf, while the Energy Information Administration estimates over 11 Tcf of additional old gas could be recovered at $2.57 per MMBtu. Thus, valuable supplies of inexpensive old gas are being inadequately developed or prematurely abandoned, while investment capital is being inefficiently allocated to more expensive supplies of new gas.

Second, the existing rates for old, flowing gas vary widely by vintage, based on the date of its dedication to interstate commerce. The overall prices consumers pay for gas depend directly on the access of their pipeline suppliers to these cheaper vintages of gas. Therefore, wide variations in pipeline access to old gas have created huge disparities in the prices consumers pay for gas at the burner-tip around the country. For example, in 1984, the average residential price of gas in Washington, DC was $8.05 per Mcf, while the average price in Kansas was $4.49 per Mcf. Kansas is served by KN Energy and Northern Natural, whose old gas "cushions" in 1984 amounted to 65 percent and 47 percent of their wellhead purchases, respectively. On the other hand, Washington, DC is served by Transcontinental Gas Pipe Line, whose 1984 old gas cushion was only 28 percent of its total purchases. Unequal access to low-cost old gas gives certain consumers and regions of the country artificial and unfair competitive advantages over other consumers and regions not served by pipelines with large "cushions" of such gas. This means consumers, purely by the historical accident of vintaging, pay different gas prices for reasons wholly unrelated to the value of the commodity or the cost of replacing it.

Third, the pricing of old, flowing gas below replacement cost gives pipelines with large "cushions" of such gas the ability to "roll-in" their prices of new and deregulated gas with artificially low old gas prices. This allows the pipelines to effectively subsidize the prices of new and deregulated gas above what consumers would otherwise be willing to pay, and therefore frustrates the efficient working of competitive wellhead markets. This cross-subsidy is unfair to consumers, because they pay above-market prices for incremental supplies of gas. It also creates distortions in the price signals which are transmitted from the wellhead to the burner-tip and back again, and thus misallocates capital and expenditures by consumers and producers alike.

In considering whether old, flowing gas rates need to be revised in order to resolve these problems, the Commission has reviewed the history of its efforts to regulate producer rates, both before and after enactment of the NGPA.

1. Producer Ratemaking Under Phillips

In 1954, the year the Supreme Court held that independent producer rates were subject to regulation under the Natural Gas Act,[39] the level of proved domestic reserves of natural gas stood at 211 trillion cubic feet (Tcf), and gas markets consumed 8 Tcf of those reserves. Wellhead prices averaged 10 cents per thousand cubic feet (Mcf), and domestic producers added more than 20 Tcf to the domestic reserve base, more than double the annual consumption rate.[40]

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[39] Phillips Petroleum Co. v. Wisconsin, ("Phillips") 347 U.S. 672 (1954).

[40] Unless noted otherwise, all statistical data and calculations in this section are derived from the following sources: U.S. Energy Information Administration ("EIA"), *NaturalGasMonthly*, Table 1 (Summary of Natural Gas Production in the United States, Consumption in the United States, 1980-January 1986), Table 5 (Projected Volumes and Prices of Wellhead Purchases by NGPA Category, 1981-March 1986), Table 6 (Estimated Surplus Natural Gas, 1981-January 1986) (February 1986) (DOE/EIA-0130(86/02)); EIA, *Natural Gas Annual 1984*, Volume I, Table 13 (Consumption of Natural Gas), Table 17 (Average City Gate Price of Natural Gas, 1984, by State), Table 19 (Average Price of Natural Gas Delivered to Consumers, 1983 and 1984, by State), Table 24 (Quantity and Average Price of Natural Gas Production, 1930-1984), Table 26 (Natural Gas Consumption in the United States, 1930-1984), (1985) (DOE/EIA-0131(84)/1); EIA, *Annual Energy Review 1984*, Table 11 (Fossil Fuel Prices, 1949-1984), Table 31 (Oil and Gas Exploration and Rotary Rigs in Use, 1949-1984), Table 32 (Exploratory Wells Completed, by Well Type, 1949-1984), Table 33 (Total Wells Completed, by Well Type, 1949-1984), Table 36 (Proved Reserves of Liquid and Gaseous Hydrocarbons, Yearend 1949-1983), Table 59 (Natural Gas Production, 1949-1984), Table 60 (Natural Gas Supply and Disposition, 1949-1984), Table 61

In 1960, six years later and the year the Federal Power Commission (FPC) formally abandoned its efforts to regulate producer rates on a case-by-case basis, the average wellhead price was only 14 cents per Mcf, despite a 50 percent increase in demand to 12 Tcf and a 30 percent decline in the average rig count over the intervening years. Proved reserves stood at 262 Tcf, but the ratio of reserves to production (R/P ratio) had declined 25 percent, from 27 to 1 in 1950 to 20 to 1 in 1960.

2. Area Rates and Vintaging

In response to the infeasibility of case-by-case ratemaking the FPC between 1960 and 1965 initiated areawide producer ratemaking with the *Permian Basin Area Rate Cases*.[41] However, the FPC based its area rates on the premise that gas contracted for *prior to* January 1, 1961, was merely a by-product of exploration for oil, and therefore "replacement cost" rates were inappropriate for such "flowing" gas. However, it relied primarily on replacement cost for setting rates for new gas. Because two different cost rationales were used to set prices for the same commodity, the experiment of "vintaging" was thus begun.[42]

Despite the FPC's area rates and first vintaging experiment, the decline in reserves and exploratory drilling

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(Consumption of Natural Gas by End-Use Sector, 1949-1984), Table 63 (Natural Gas Wellhead and Import Prices, 1949-1984) (April 1985) (DOE/EIA-0384(84)); EIA, *U.S. Crude Oil, Natural Gas, and Natural Gas Liquids Reserves, 1984 Annual Report* (September 1985), discussed in Wingenroth and Davis, "U.S. Natural Gas Reserves Statistics," *Gas Energy Review* (Vol. 13, No. 11, American Gas Association, November 1985).

[41] Statement of General Policy No. 61-1, 24 FPC 818 (1960); Opinion 468, 34 FPC 159, Opinion 468-A, 34 FPC 1068 (1965), *aff'd* Skelly Oil Co. v. FPC, 375 F.2d 6 (10th Cir. 1967), *aff'd* Permian Basin Area Rate Cases, *supra*, 390 U.S. 747 (1968).

[42] Opinion 468, 34 FPC at 186-87 (1965).

continued. Between 1960 and 1972, wellhead prices rose five cents, from 14 cents per mcf to 19 cents per mcf. At the same time, gas demand increased substantially from 12 Tcf to 22 Tcf and proved reserves declined from a peak of 293 Tcf in 1967 to 266 Tcf in 1972 and 228 Tcf in 1975, a 22 percent drop in eight years. The average rig count hit a 20-year low of 976 in 1971 and curtailments of gas supplies to the interstate market began.[43]

[43] H.R. Rep. No. 95-496, Part 4, 95th Cong., 1st Sess. (1977), "Committee on Interstate and Foreign Comerce, H.R. 6831), "National Energy Act", at pp. 90-92. "Beginning in 1967 and continuing in each succeeding year up to the present, U.S. natural gas consumption has exceeded additions to proven reserves in the contiguous 48 states . . . Moreover, due to increasing demand for natural gas and relatively stable rates of production, annual demand for natural gas has exceeded natural gas production since 1973. As a result, many interstate natural gas pipeline companies have been increasingly unable to meet their contractual delivery requirements to customers in many regions of the country. Many natural gas distribution companies have in turn found it necessary to deny gas service to new customers and to curtail service to some existing customers. Firm curtailments reported by interstate pipelines have grown from 1.0 Tcf during the April 1970 through March 1971 delivery year to 3.4 Tcf during the 1976-77 delivery year. The Federal Power Commission projects that firm curtailments will reach 3.8 Tcf during the 1977-78 delivery year. This would amount to 26.6 percent of firm requirements.

"In response to the rapid expansion in natural gas demand, unregulated intrastate natural gas prices rose above regulated interstate prices. During the period from 1969 to 1976, interstate natural gas prices for new contracts rose by "more than 700 percent, from approximately 19.8 cents per Mcf to over $1.42 per Mcf. However, during the same period, intrastate natural gas prices rose at an even greater rate, from approximately 18 cents per Mcf in 1969 to as high as $2.39 per Mcf in 1977, better than a 1,300-percent increase.

"As a result of the recently developed disparity in natural gas prices between the intrastate and interstate markets, new discoveries of natural gas reserves have been sold with increasing frequency in the intrastate, rather than the interstate, market. In large measure, present stable supply conditions in intrastate markets have resulted from the inability of the interstate market to compete for new supplies of natural gas.")

3. National Rates

When it became clear to the FPC that area rates were too low to call forth adequate supplies for interstate consumers, the Commission initiated national rate proceedings in 1973 in order to stimulate increased production.[44] In these proceedings, Commission found that its different vintages of area rates were distorting gas prices not only below the current replacement cost of gas, but also below the actual market prices for alternative fuels, such as oil. As a result, the FPC determined to phase-out the "vintaging" of rates for old and new gas.[45] In a companion proceeding, the Commission also determined to collapse all pre-1973 vintages of old, flowing gas into one minimum national rate.[46] The Commission found that "there is no rational basis for setting differing price levels based upon date of discovery," and therefore determined to establish "a uniform base price for gas sold in interstate commerce, which equates to the cost of replacing the unit of gas consumed." [47]

But in 1976, the FPC partially reserved itself, and in Opinions No. 770 and 770-A reinstated a limited form of vintaging for both pre-1973 vintages and 1973-1974 "biennium" gas.[48] The Commission justified its decision by noting that it was nearly tripling the base rate for *new* post-1974 gas supplies from $0.52 per Mfc to $1.42 per Mcf, and therefore had "carefully scrutinized the disparity between new prices and old prices to avoid an

[44] *See* Opinion No. 699-H, *supra*; Opinion No. 749, *supra*.

[45] Opinion No. 699-H, *supra*, 52 FPC 1604, 1636-38 (1974).

[46] Opinion No. 749, *supra*.

[47] Opinion No. 699-H, *supra*, 52 FPC at p. 1636-38.

[48] Opinion No. 770, *supra*, 56 FPC 509, 521 (1976).

unreasonable increase in rates." [49] However, the FPC restated its previous finding that "it is only fair that consumers of 'flowing gas' share the burden of financing the added exploration" and its intention to apply rates for flowing gas "functionally in order to assist in the generation of sufficient capital for expanded exporation and development programs." [50]

4. The Failure of National Rates and Adoption of the NGPA

Despite the adoption of new national rates for new and flowing gas, average wellhead prices continued to be below the Btu-equivalent prices of alternative fuels following the 1973-4 OPEC oil embargo. Curtailment of gas supplies to interstate markets widened between 1973 and 1977, culminating in the emergency gas shortages of the winter of 1976-1977.[51] Proved reserves continued their decline, reaching a thirty-year low of 195 Tcf in 1979, despite stable levels of demand averaging about 20 Tcf between 1972 and 1979. And in spite of the increase in average wellhead prices from 30 cents per Mcf in 1974 to 91 cents per Mcf in 1978, reserve additions in the lower-48 states averaged only 46 percent of annual production during the decade preceding enactment of the NGPA.[52]

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[49] *Id.*, at 523.

[50] Opinion No. 770-A, *supra*, 56 FPC 2698, 2714-15 (1976).

[51] H.R. Rep. No. 95-496, Part 4, "National Energy Act," *supra*; *see also* Emergency Natural Gas Act of 1977, P.L. 95-2, 91 Stat. 4, enacted by Congress in early 1977 in eight days, as an urgent response to a severe natural gas shortage endangering the supply of natural gas for high-priority uses. The Act gives the President extraordinary authority to declare a natural gas emergency and mandate transportation and sale of natural gas to meet the requirements of high-priority users.

[52] Wingenroth and Davis, "U.S. Natural Gas Reserves Statistics," Gas Energy Review (Vol. 13, No. 11, AGA, November 1985) ("Overall, reserve additions in the lower-48 states [in 1984] were 82.4% of production, thus for the period of 1981-1984 reserve additions in the lower-48 states have averaged 96%. This compares with a 46% replacement level during the decade preceding enactment of the Natural Gas Policy Act of 1978.")

The NGPA interrupted the Commission's third national rate proceeding in five years.[53] It did this by comprehensively removing new gas from the NGA jurisdiction of the Commission, by establishing new ceiling price categories for new and high-cost gas, and by setting incentive prices for certain marginal old gas supplies ("stripper wells"). The NGPA also partially removed the Commission's NGA jurisdiction over old, flowing gas, by incorporating the then-existing national rate structure for such gas into the statute, and applying to it an annual inflation factor. However, the NGPA authorized the Commission in its discretion to revise old, flowing gas rates as long as it revised the rates up, not down, and as long as it determined that such revised rates were "just and reasonable within the meaning of the Natural Gas Act." [54]

Finally, to protect against interstate pipelines "bidding up" new gas prices above market-clearing levels due to the "rolled-in" pricing of disparate prices for old and new gas, the NGPA established a scheme of incremental pricing to allocate a disproportionate share of higher gas prices to those major fuel-switchable users expected to be most able to "bargain down" any such "bidding up." [55]

The alternative fuel ceiling on which incremental prices were based under the NGPA had little effect on the bidding-up of new gas prices. The Commission in

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[53] National Rates for Jurisdictional Sales of Natural Gas From Wells Commenced On or After January 1977, For the Period January 1, 1977, to December 31, 1978, Docket No. RM77-13, 57 FPC 1238 (1977).

[54] 15 U.S.C. §§ 3314(b)(2), 3316(c).

[55] Statement of Rep. Dingell, 95 Cong. Rec. H13114 (daily ed. October 14, 1978).

1980 declined to expand incremental pricing to smaller fuel-switchable users, and its decision was supported in Congress.[56]

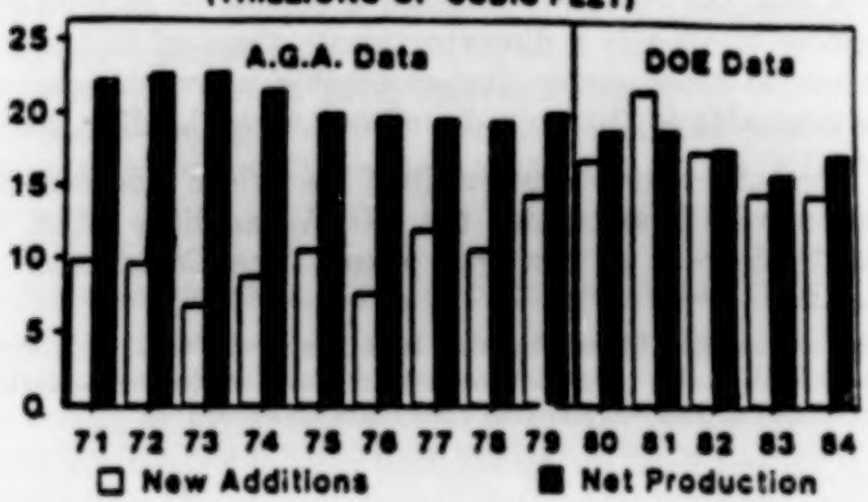
5. Market Disorders Under the NGPA

The market initially responded to the NGPA with a boom in drilling. The average rig count jumped from 2001 in 1977 to 2909 in 1980 and 3970 in 1981. Exploratory gas well completions, which had hit a low of 470 in 1971, jumped from 1560 in 1977 to 2550 in 1981.

However, this drilling boom could be misleading. Although average wellhead prices increased from 91 cents per Mcf in 1978 to $1.98 per Mcf in 1981, additions to reserves continued to fall short of replacing production, even though lower-48 additions did increase to 90% of production for the period 1978-84, as Figure 1 indicates.

Figure 1

NET PRODUCTION AND NEW ADDITIONS TO GAS RESERVES (TRILLIONS OF CUBIC FEET)



[56] For an explanation of the effect of incremental pricing on new gas prices, *see* H.R. Rep. No. 96-938, 96th Cong., 2d Sess. (1980), H Res. 655, "Incremental Pricing of Natural Gas," Committee on Interstate and Foreign Commerce.

Although the NGPA stimulated drilling and new gas production, it also expanded the categories of old and new gas subject to different price ceilings and for the first time extended price ceilings to the previously unregulated intrastate market.[57]

For example, the average wellhead price of "old" gas in November 1978 was approximately 90 cents per Mcf, rising to $1.62 per Mcf by January 1983, before stabilizing between $1.40 to $1.45 per Mcf since 1983. The average price of "new" gas rose from $2.03 per Mcf in December 1978 to $3.75 in December 1984, a nearly 85 percent increase in six years. But the average price of "high-cost" gas under section 107 of the NGPA went for a roller-coaster ride, up from approximately $5.70 per Mcf in early 1981 to a peak of $7.31 per Mcf in 1982, before plummeting to $3.89 per Mcf by February 1986—a 28 percent increase followed by a 47 percent fall in only five years.

However, disparities in wellhead prices were not the only fact of life under the NGPA. Beginning in 1982, alternative fuel prices stabilized and then fell, accompanied by an economic slowdown and warmer than normal weather. What happened next was a 17 percent decline in gas consumption between 1979 and 1983, coinciding with the NGPA drilling boom and the rush by interstate pipelines to bid up prices of new and high-cost gas committed to the interstate market.

By 1982, pipelines were stuck with large volumes of unmarketable new and high-cost gas whose above-market prices contrasted with their below-market priced old gas. As oil prices fell below equivalent burner-tip prices of gas, large fuel-switchable users shifted to oil, and the pipelines were forced to raise their city-gate prices in

[57] 18 CFR 271.501-504, 601-603 (1985); 15 U.S.C. 3315, 3316(b) (1982).

order to recover the costs of their unmarketable gas and fixed transmission costs from a decreasing customer base.[58]

These market disorders, attributable by many to the distortions in wellhead purchasing practices caused by vintage pricing and the NGPA itself,[59] created the para-

[58] H.R. Rep. No. 98-814, 98th Cong., 2nd Sess. (1984), Committee on Energy and Commerce, H.R. 4277, "Natural Gas Market Policy of 1984" at pp. 22-24. (" . . . The drop in the world oil price late in 1982 caused residual fuel oil prices to fall below natural gas prices, so that those industrial plants capable of doing so switched from gas to oil. In response to steadily increasing prices, significant conservation was achieved by industrial, commercial, and residential users. In the winter of 1983, abnormally warm weather reduced space heating demand for gas by residential and commercial users . . . [T]he loss of large blocks of gas sales on any given system leaves the remaining customers paying a larger share of the fixed costs of the transmission and distribution systems.").

[59] S. Rep. No. 98-205, 98th Cong., 1st Sess. (1983), Committee on Energy and Natural Resources, S. 1715, "Natural Gas Policy Act Amendments of 1983" p. 10 ("In part the NGPA is not operating as originally designated . . . [W]hat was not fully appreciated was that despite Federal cost-passthrough regulations, pipelines could in effect use this 'cushion' [of 'old' price-controlled gas] to subsidize the acquisition of new and deregulated gas supplies. This occurs as a result of 'rolled in' gas pricing whereby a pipeline's customers are charged the average price of the gas they are consuming, rather than the marginal cost of new gas supplies."); Comments of Natural Gas Supply Association (NGSA), Docket RM85-1-000 (Parts A-D), at p. 1 (NGSA "believes that current disorders in the natural gas market can only be eliminated if the industry is placed on a true competitive footing. This can be accomplished if . . . (ii) existing market distortions resulting from prior regulatory policies are eliminated."); *Maryland People's Counsel v. FERC*, 761 F.2d 770-71 (1985) ("The problem ultimately giving rise to the present litigation is that the 1978 predictions of the 1985 market were much in error. Factors ranging from the increased wellhead prices and impending total decontrol, to greater energy conservation, to the lower prices of competing fuels, have turned the natural gas shortages of the 1970's into a natural gas surplus. Thus, as early as the summer of 1983—a year and a half before the scheduled deregulation of new gas—the formulary

dox of 1982-1984: The city-gate price to consumers of gas went up in the midst of a surplus of deliverability and declining demand.

In response to these market disorders at both ends of the pipe, the Commission between 1982 and 1985 made a number of changes in its regulations. For example, in response to fuel-switching by industrial users, the Commission authorized, on an experimental basis, special marketing programs for the transportation of "self-help" gas to fuel-switchable users by producers willing to provide take-or-pay relief to their pipeline purchasers. Likewise, in order to ensure that post-1982 wellhead contracts were more market-responsive, the Commission adopted a presumption that take-or-pay requirements in excess of 75% were imprudent in new wellhead contracts. In order to ensure that all gas consumers would share in the benefits of increased gas-on-gas competition caused by lower demand and falling oil prices, the Commission promulgated

statutory maximum price for new gas had already reached or exceeded the market-clearing price in many geographic markets");

Testimony of C. M. Butler III, Chairman, Federal Energy Regulatory Commission, before Committee on Energy and Natural Resources, United States Senate, November 5, 1981, p. 2 (. . . the most serious deficiency of the NGPA has not been its complexity or the dependence on the active participation of state agencies, but rather the statute's establishment of a new *dual market*, that is, one in which some gas prices are regulated while others are not . . . . The market-ordering problems created by NGPA's regime of partial regulation are already evident in the prices being paid for deregulated gas and in the supply problems of some interstate and intrastate pipelines.");

Testimony of George H. Lawrence, President, American Gas Association, before the Subcommittee on Energy Regulation and Conservation, United States Senate, July 11, 1985, p. 5 (citing "the dramatic improvement in natural gas supplies since the NGPA was enacted. These supply improvements in response to the higher NGPA prices have demonstrated conclusively that interstate market gas supply problems during the 1970's reflected the inadequacies of wellhead price controls rather than the limits of the domestic gas resource base.")

a rulemaking prohibiting pipelines from including variable costs for gas not taken in the minimum bills they charge their sales customers at the city-gate.[60] However, the Commission considered but failed to adopt any changes to its vintage rates for old, flowing gas.[61]

Despite increased competition and changed regulations at the city-gate, demand failed to revive with the general economic recovery in 1984. Immediately prior to partial wellhead deregulation in 1985, wellhead prices widely diverged among different categories and on different pipeline systems, with some categories of new and high-cost gas still averaging $3.93 per Mcf while old gas remained at $1.54 per Mcf. Finally, by the end of 1984, the marketplace was still failing to clear some 3 Tcf of surplus deliverability that had built up since 1981.

6. Natural Gas Markets Since January 1, 1985

The Commission adopted rules to implement the partial deregulation of new gas on January 1, 1985, as required by the NGPA, even over the objections of some producers that deregulation would subject them to lower prices instead of their higher contract prices pegged to regulated price ceilings.[62]

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[60] *See Tenneco Oil Co., et al.*, 28 FERC ¶ 61,383, *order on reh'g*, 29 FERC ¶ 61,334 (1984); *Maryland People's Counsel v. FERC*, 761 F.2d 768 (D.C. Cir. 1985); *Maryland People's Counsel v. FERC*, 761 F.2d 780 (D.C. Cir. 1985); Statement of Policy on Take-or-Pay Provisions in Gas Purchase Contracts, Docket No. PL83-1-000, 3 FERC Stat. and Reg. ¶ 30,410 (1982), 47 FR 57268 (1982), (*codified* at 18 C.F.R. part 2) Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, 49 FR 22778 (June 1, 1984) (Order No. 380); *order on reh'g*, 49 FR 31259 (August 6, 1984), *aff'd, Wisconsin Gas Co. v. FERC*, 770 F.2d 1144 (D.C. Cir. 1985).

[61] Impact of the NGPA on Current and Projected Natural Gas Markets, 47 FR 19157 (May 4, 1982) (Docket No. RM82-86). The Commission formally incorporates the public record in Docket No. RM82-86 into the record of this proceeding.

[62] Deregulation and Other Pricing Changes on January 1, 1985, Under the Natural Gas Policy Act, 49 FR 46874 (Nov. 29, 1984)

In anticipation of further competition at the city-gate following partial wellhead deregulation, the Commission engaged in a year-long inquiry into its policies governing the transportation of gas for others, and the impact of its policies on the industry's ability to respond to the new competition. Following this inquiry, the Commission adopted comprehensive regulatory changes designed to encourage pipelines to offer non-discriminatory access to transportation services, in return for providing pipelines with regulatory flexibility to provide such services.[63]

In the same docket, the Commission continued to review wellhead market disorders, this time focusing on the ability of pipelines to purchase deregulated or high-cost natural gas at above-market prices, and then to "roll-in," or otherwise subsidize, those high prices at the city-gate with below market prices for regulated "old" gas.[64]

Despite these further regulatory changes, the first year of partial wellhead deregulation failed to eliminate wellhead price disparities. Prices in the burgeoning spot gas market declined from approximately $3 per Mcf to close to $2 per Mcf through the year. Similarly, the average wellhead price of new gas fell from $3.78 per Mcf to $3.33 per Mcf over the 12-month period, despite the predictions by some that wellhead prices would "fly-up" on January 1, 1985.[65] But in spite of an overall 15 percent

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(Order No. 406); *order on reh'g*, 49 FR 50637 (Dec. 31, 1984) (Order No. 406-A).

[63] Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 42,408 (October 18, 1985), *order on reh'g*, Order No. 436-A, 50 FR 52217 (Dec. 23, 1985).

[64] Order No. 436, *supra*, Notice Requesting Supplemental Comments (Docket No. RM85-1-000 (Part D)).

[65] "Analysis of Price Fly-Up Under the Natural Gas Policy Act," April 1984, Interstate Natural Gas Association of America ("In the absence of significant renegotiation or a legislative solution, nonmarket sensitive price and take provisions in existing contracts

decline in the weighted average cost of gas to interstate pipelines between February 1985 and February 1986, average monthly gas utility prices at the city-gate declined only 5 percent over the same period.[66] This lag in city-gate prices persists at a time when demand continues to be soft and wellhead markets continue to face over 3 Tcf in surplus deliverability.

Today, ten years after the Commission partially reinstated vintaging and one-and-a-half years after partial decontrol, the inequality of incentives for production has widened, not narrowed. Four trillion cubic feet of gas, 43% of wellhead purchases by interstate pipelines, remains subject to base rates which have not been updated since 1976. Of the 4 Tcf of old, flowing gas, 2.1 Tcf, or 25 percent of all interstate purchases, is subject to

will push the average wellhead price up to 9% to 12% above inflation in 1985."); "C/LEC's Rothschild Out to Capture Competitive Benefits for Consumers," *Inside FERC's Gas Market Report*, April 18, 1986, at p. 3 ("The Citizen/Labor Energy Coalition, once a staunch opponent of gas price deregulation, now believes that in markets that are competitive, regulation is not necessary, says Edwin Rothschild, assistant director and chief Washington lobbyist . . . 'We were wrong,' Rothschild willingly admits about the predictions of a catastrophic runup in gas prices that C/LEC made about the effect of partial gas-price decontrol on Jan. 1, 1985. While conceding that gas prices have gone the opposite way from C/LEC's projections. Rothschild added that 'we were in wonderful company, AGA, most of the financial analysts and the pipelines were also wrong about the price direction as well.' "); Testimony of George H. Lawrence, President, American Gas Association, before Subcommittee on Energy Regulation and Conservation, Committee on Energy and Natural Resources, United States Senate, April 15, 1986 ("The ultimate goal should be to make all gas, old and new, market-responsive. In today's volatile energy marketplace, which is dominated by rapidly declining crude oil and product prices, we need to do everything possible to stimulate gas demand by making prices more market-responsive and removing outdated constraints on its use . . . The best solution to the take-or-pay problem has always been to sell more gas.")

[66] Monthly Gas Utility Statistical Report, American Gas Association, January 1986.

rates substantially below even current spot prices of $2 per Mcf.[67] As of March 1986, the average wellhead price of all vintages of old, flowing gas is $1.39 per Mcf, $1.08 (44 percent) below the $2.47 per Mcf average price for all wellhead purchases by major interstate pipelines.

Massive disparities in consumer gas prices persist across different pipeline systems and region of the country. In 1984, average delivered gas prices to consumers in the continental U.S. varied from a high of $9.58 and $8.80 per Mcf in Maine and Connecticut, to a low of $4.37 and $4.49 per Mcf in Arkansas and Kansas. Pipeline purchased gas costs in 1984 varied, because of unequal access to old gas, from a low of $1.71 and $2.12 per Mcf on KN Energy and Northwest Central pipelines, respectively, to a high of $3.95 and $3.60 per Mcf on Columbia Gas Transmission and Trunkline, respectively.[68] This unequal access to old gas persists even though eight years have elapsed since Congress enacted the NGPA, a statute expressly intended to create a uniform national market for gas at the wellhead.[69]

The current surplus deliverability of gas cannot blind this Commission to the data on long-term supply reliability. In 1984, according to EIA, proved gas reserves fell to their lowest level since 1979. In addition, AGA in its "1986 Base Case" for gas supply and demand, issued before the 1986 collapse in world oil prices, has projected that under current wellhead price regulations, exploratory oil and gas drilling activity in the lower-48 states will continue to fall from approximately 11,000 wells in

[67] EIA, "An Analysis of Natural Gas Contracts, Volume I: Old Interstate Gas," *Service Report*, Table 3 (February 1986) (RNGD-86-01) (hereafter "EIA Old Gas Study").

[68] EIA Old Gas Study, *supra*, at Table 4.

[69] *Public Service Commission of New York v. Mid-Louisiana Gas Co.*, 463 U.S. 319, 330-1 (1983); Joint Explanatory Statement of the Committee on Conference, H.R. 5289, Natural Gas Policy Act of 1978, at 67.

1985 to under 8,000 in 1995 and under 7,000 by the year 2000. The result, according to AGA, will be a precipitous decline in lower-48 conventional natural gas reserve additions from over 15 Tcf in 1985 to under 11 Tcf in 1995 and 10 Tcf by the year 2000. In other words, AGA projects, under current wellhead prices, "the combined effect of falling discoveries and more stable extensions and revisions is a reduction in the level of total reserve additions of 41 percent between 1985 and 2000." [70] The gap between domestic conventional reserve additions an imports and unconventional sources, according to AGA, will grow from 4 percent of supplies in 1985 to 20 percent in the year 2000, under current wellhead regulations.

AGA has recently updated its "1986 Base Case" projections to reflect substantially lower oil prices.[71] According to the update, lower wellhead natural gas and oil prices will reduce future exploratory drilling activity by an additional 8 percent if oil prices average $20 per barrel; and by an additional 20 percent if oil prices average $15 per barrel, compared with the "1986 Base Case" assumption of $25 per barrel. These lower levels of drilling activity, says AGA, could reduce future gas reserve additions by an additional 6 percent in the $20 per barrel case and by 17 percent in the $15 per barrel case. In other words, the bad news for future drilling prospects in the "1986 Base Case" only gets worse in AGA's update.

7. The New Just and Reasonable Ceiling Price

In setting a new single just and reasonable ceiling price for all vintages of old, flowing gas, the Commission has considered a number of factors.

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[70] Initial Comments of American Cas Association, Appendix B attaching "A.G.A.-TERA BASE CASE 1986-I" (hereafter "AGA 1986 Base Case"), Docket No. RM 86-3-000.

[71] "AGA Analysis Shows Effect of Oil Prices on Natural Gas Sales," *Washington Letter* (American Gas Association, April 18, 1986) at 5-6.

The Commission has determined that the new ceiling price should be set at the *replacement* cost of old, flowing gas, not its *original* cost. The Commission is obligated under the NGA to assure consumers long-term reliable gas service at reasonable cost. To the extent original-cost rates do not reflect the replacement cost of depleted reserves, such rates fail to assure adequate supply and therefore fail to fulfill the goals of the NGA. In addition, original-cost rates represent, in part, an effort by previous Commissions to keep *old* gas rates artificially low, in order to offset any immediate increases in consumer prices due to higher *new* gas rates. These efforts did not prevent gas shortages before the enactment of NGPA, and the NGPA itself has removed the Commission's jurisdiction to increase new gas rates. For all these reasons, the Commission concludes that it should not use original cost methodology as a "back-door" means of keeping old gas prices artificially low in order to offset the higher, market-based prices for new gas mandated by the NGPA.

However, the Commission's authority over old gas ceiling prices under the NGPA is limited to *raising, not lowering* such ceiling prices. In addition, *any* effort to define the current "replacement cost" of gas must take into account the distortions and disorders which already exist in gas markets today. Therefore, the Commission cannot unduly rely on price signals in those markets as an absolutely accurate measure of "replacement cost." Finally, the NGPA itself constitutes a finding that wellhead markets are workably competitive, but gives the Commission little guidance—besides the NGA "just and reasonable" standard—on how to exercise its own NGPA discretion to raise old gas ceiling prices beyond their previous, primarily original-cost based levels. The highest numerical level set by the NGPA for old gas ceiling prices is that for the post-1974 vintage, currently $2.57 per MMBtu.

Third, the Commission's NGPA discretion permits it to mitigate, but not entirely eliminate, disparities in gas prices. It can only set new ceiling prices for old gas under NGPA sections 104, 106, and 109, and cannot revise the maximum lawful price ceilings for gas still regulated under sections 102, 103, 105, and 108. Nor can it set rates for old gas; it can only set maximum lawful ceiling prices for purposes of the NGPA. Thus, any new ceiling prices for old, flowing gas will not eliminate all price distinctions between old gas, still-regulated new and high-cost gas, and deregulated gas.

Fourth, recognizing the difficulties in calculating the erplacement cost of gas, the Commission has considered a range of other wellhead prices as criteria for a just and reasonable ceiling price. For example, the Commission notes the current conditions in gas markets, where spot gas prices are below $2 per Mcf, and "market-responsive" contracts are not getting much more.[72] It also notes that pipeline WACOGs are still averaging in the $2.50 range, long-term contract prices for new gas are in the same range, and oil and gas drilling has collapsed in response to plummeting energy commodity prices.[73] This collapse in drilling, coupled with declining reserve replacement in 1985, indicates current short-term prices for gas are actually below the long-term replacement cost of gas, thereby undermining incentives to drill for new supplies. Finally, the Commission has also reviewed these long-term downward trends in reserve replacement, and notes that the existing proved reserve base reflects a mixture of already-

[72] *E.g.*, "Spot Gas Prices Down," *The Energy Daily* (May 6, 1986), p. 1 (citing spot gas wellhead prices ranging between $1.35/MMBtu and $1.70/MMBtu on eight interstate pipeline systems for contracts of 1-6 months duration).

[73] *See Natural Gas Month*, *supra*, Table 5; "An Analysis of the Department of Energy's Notice of Proposed Rulemaking (NOPR), 'Ceiling Prices: Old Gas Pricing Structure,'" *Service Report*, EIA, May 1986 at figure 1-4 (RNGD-86-03). The oil and gas active rotary rig count was 757 for the week ending May 19, 1986.

discovered old gas fields and new gas fields yet to be developed in expensive frontier areas such as the outer continental shelf (OCS).[74]

For these reasons, and as discussed in more detail herein, the Commission has determined that the just and reasonable ceiling price is within a "zone of reasonableness" which represents the current replacement cost of gas established in Part IV, *infra*.

Within this range, the Commission has also determined that a new single just and reasonable ceiling price for all vintages of old, flowing gas should be no higher than the lowest price in the range of replacement cost, the current $2.75 per MMBtu price for post-1974 flowing gas, escalated for inflation. This ceiling price is within the zone of reasonableness for replacement cost, but is no higher than the highest vintage rate Congress itself retained for flowing gas under the NGPA. This price is the minimum necessary to permit producers to recover the cost of capital to replace depleted reserves over the long-term. Because this price does not exceed the highest cost-based price set by Congress for old gas, it is also a price which protects consumers against exploitation by producers inconsistent with the competitive conditions in wellhead markets, mandated by the NGPA. As natural gas markets evolve further under competitive conditions, the Commission will review this new national ceiling price to assure that it remains within the zone of reasonableness for replacement cost.

Furthermore, as an integral part of the new ceiling price itself, the Commission is adopting a "good faith

[74] See generally, U.S. Natural Gas Availability: *Gas Supply Through the Year 2000* (Washington, DC: U.S. Congress, Office of Technology Assessment, (OTA-E-245, February 1985) (hereafter "OTA Report"); AGA Gas Supply Committee, "Conventional Natural Gas Production in the Lower-48 States Through 2010," *Gas Energy Review* (Vol. 13, No. 11, American Gas Association, November 1985) (hereafter "AGA Gas Supply Committee Report").

negotiation" procedure which prevents any producer from automatically collecting a higher price under an existing contract unless a purchaser expressly agrees and unless the producer is willing to renegotiate certain other gas contracts the purchaser considers non-market responsive. Finally, in order to protect a pipeline's firm sales customers from any adverse impacts on their existing gas services, the new ceiling price provides such customers a right of first refusal and transportation authority for gas released by a pipeline under the good faith negotiation procedure. The implementation of the good faith negotiation procedure itself is delayed until November 1, 1986 in order to permit voluntary price renegotiation before any gas is released under the rule.

III. Summary of the Rule Adopted

The rule adopted today by the Commission represents an endorsement of the objectives set forth in the DOE proposal, modified to recognize the current needs of the natural gas market for regulatory change and the most practical means of meeting those needs. Before specifically addressing the issues presented by comments in the record, the Commission offers the following summary of the changes in its regulations that will become effective July 18, 1986.

Part 271 of the Commission's regulations governs ceiling prices for all categories of natural gas. It includes a table (§ 271.101(a), Table II) that specifies the maximum lawful prices (MLPs) for all vintages of gas subject to NGPA sections 104 and 106(a). Subpart D of Part 271 implements the NGPA's maximum lawful prices for old gas sold in interstate commerce, namely, gas subject to NGPA sections 104 and 106(a). Subpart F implements those prices for old gas sold under intrastate rollover contracts, if the gas is not otherwise deregulated. This gas is subject to NGPA section 106(b).

The new rule provides an alternative MLP for all vintages of gas under NGPA sections 104 and 106 at the

price set forth in Table II for post-1974 gas, currently \$2.57 per MMBtu, subject to an inflation factor adjustment. The Commission amends § 271.402(c) to make available the higher MLP for sections 104 and 106(a) gas as an alternative to the otherwise applicable vintage prices. A producer of sections 104 and 106(a) gas may collect a price up to the alternative MLP if the price is established under a contract provision executed by the purchaser after July 18, 1986, or the purchaser has agreed to pay a higher price under the terms of an existing contract. Therefore the rule precludes the automatic effectiveness of indefinite price escalator clauses in existing contracts and ensures that a purchaser will not be obligated to pay the higher price after promulgation of this rule unless it agrees to continue purchases under an existing contract.

Under § 271.602, which pertains to MLPs under intrastate rollover contracts, the Commission also allows collection of the MLP listed for post-1974 gas in Table II, if it is higher than the older available prices specified, but only if the price is established under a contract provision executed after July 18, 1986.

The final rule also establishes a good faith negotiation procedure under a new § 270.201. The negotiation procedure is available to a producer whose interstate contract provides for escalation of the contract price to a higher MLP. This negotiation rule grants producers abandonment if the producer seeks a higher price for its old gas, is unable to agree with the purchaser on a suitable price, and finds another purchaser. If the tentative new purchaser is not a firm sales customer of the existing purchaser, and the existing purchaser is not an open-access transporter under Order No. 436, firm sales customers of the existing purchaser have a right of first refusal. The rule applies to renegotiations of the price for sales under contracts in effect on the effective date of the rule as well as sales made under certificates of

public convenience and necessity where the underlying contract has expired. However, formal negotiations under the rule may not begin prior to November 1, 1986. The abandonment provisions of the rule are not available for gas sold under interstate contracts that do not provide for escalation of the contract price to a higher MLP or for gas sold under intrastate rollover contracts. However, the price of gas sold under such contracts may be increased up to the new higher MLP if the producer can nevertheless secure the purchaser's agreement to a higher price.

Producers will be granted blanket certificates of public convenience and necessity authorizing the sale of gas abandoned under the provisions of this rule, as well as authority to abandon future sales of such gas upon termination of the contract. The rate filing requirements for sales of such gas under existing regulations are waived. However, producers will be required to report annually to the Commission on their jurisdictional sales of gas abandoned pursuant to this rule.

Interstate pipelines that are not open-access transporters under the provision of Order No. 436 will be granted blanket transportation certificates and will be deemed to have agreed to deliver on behalf of any shipper any gas released under this rule to any of its existing customers or interconnected pipelines. Pipelines will not become open-access transporters by virtue of transportation performed under the blanket certificate.

The mechanics of the good faith negotiation rule are as follows. The producer may, at any time after October 31, 1986, request in writing that the purchaser nominate a price it is willing to pay for the producer's old gas. Such a request constitutes an offer by the producer to release the purchaser from its obligation to continue purchasing gas subject to price renegotiation under the good faith negotiation rule. If the purchaser does not respond within sixty days, the producer may enter into a written

contract for the sale of the gas to a new purchaser, subject to a right of first refusal by firm sales customers of an existing purchaser which is not an open-access transporter under Order No. 436, and thereafter abandon sale of the gas to the existing purchaser upon 30-days' written notice. However, if the purchaser responds by offering the highest price permitted under the existing or expired contract up to the alternative MLP, the producer must accept the offer and continue to sell the gas to the purchaser.[75] Alternatively, the producer may accept or reject any price offered below the highest price permitted. If the producer accepts, sales continue at the agreed-upon price. If the producer rejects the offer and enters into a written contract with another purchaser, the producer is granted abandonment.

The interests of purchasers are protected by permitting them to request the producer to nominate a price at which it will continue to sell any gas being sold under any contract sought to be renegotiated by the producer as well as any gas under any or all contracts with that producer which provide for the sale of any old gas. If the purchaser rejects the price nominated by the producer, the purchaser may accept the producer's offer of a release and terminate its contractual obligation to take the gas after 30-days' notice. Once the purchaser discontinues purchasing the gas, terminating its contractual obligation under authority of this rule, the producer is granted authority to abandon sale of the jurisdictional gas to the purchaser.

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[75] An offer of the highest permitted price must conform to all other terms of the contract. A purchaser may not, for example, preclude the producer's rejection by offering the highest permitted price for only a portion of the volume of takes required by the contract. If a contract with an indefinite price escalator clause has been superseded by a contract amendment imposing a temporary cap on the price of the gas, the highest permitted price would be the temporary cap until expiration of tht amendment and, thereafter, as provided by the indefinite price escalator clause.

The right to renegotiate under this rule, with the attendant rights of abandonment and contract termination, are available only once for each contract. If a producer has initiated negotiations under the good faith negotiation rule, or the producer and purchaser have agreed on the price of gas after July 18, 1986 whether or not after negotiations in accordance with the rule, the abandonment and contract termination rights are not subsequently available for any gas sold under the contract in question. However, nothing in the rule precludes the parties from thereafter negotiating mutually agreeable revisions in price or other terms of their contracts.

IV. Raising the Maximum Lawful Price for Old Gas

A. *Scope of Commission Authority*

The Commission's adoption of the old gas proposal is predicated on the exercise of its authority under sections 104(b)(2) and 106(c) of the NGPA. These sections provide that the Commission may prescribe a maximum lawful price for any first sale (or category thereof) which is higher than the otherwise applicable price, provided the higher price is "just and reasonable within the meaning of the Natural Gas Act." [76] DOE argues that the Commission has wide discretion to establish the structure as well as the level of just and reasonable rates for old gas consistent with applicable standards and precedent developed under the NGA, including authority to

[76] The text of section 104(b)(2) is as follows:

(2) Ceiling prices may be increased if just and reasonable—

The Commission may, by rule or order, prescribe a maximum lawful ceiling price, applicable to any first sale of any natural gas (or category thereof, as determined by the Commission) otherwise subject to the preceding provisions of this section if such price is—

(A) higher than the maximum lawful price which would otherwise be applicable under such provisions; and

(B) just and reasonable within the meaning of the Natural Gas Act.

eliminate vintaging of old gas and to consider both cost and non-cost factors in establishing ceiling prices.

In the notice of December 20, 1985, the Commission requested comments concerning its legal authority to establish new just and reasonable rates under NGPA sections 104 and 106. The Commission noted that the cost-based methodologies used in the past to establish just and reasonable rates were developed in the context of different market conditions which were not competitive and a different regulatory framework from that which exists today. The Commission requested comments concerning the legal and practical effects of using prior methodologies and the extent to which the Commission may rely on non-cost factors in determining just and reasonable rates. The Commission also expressly requested the commenters to include quantitative as well as qualitative analyses of the legal, policy, economic and technical issues raised in the DOE proposal.

Comments. Numerous opposing commenters argue that the old gas proposal is beyond the scope of Commission authority and therefore cannot be lawfully adopted. Their position is that Congress, acting through the NGPA, has established a permanent, unalterable pricing system for old gas and that the Commission's authority to raise rates under NGPA sections 104(b)(2) and 106(c) is limited to adjustments that reflect increases in costs that are not adequately compensated for by the NGPA's inflation adjustments, or on a case-by-case basis, where production has become uneconomic under existing prices.[77] Opposing commenters also cite certain legislative history as authority for the proposition that Congress did not

[77] Maryland People's Counsel—National Association of State Utility Consumer Advocates (MPC-NASUCA) at 3-7; New York Public Service Commission (New York) at 3-13; *see also* California PUC at 5-12; Arkansas PSC at 4; PSC of Wisconsin at 2-5; PSC of West Virginia at 6-9; PSC of Kentucky at 1-4; PSC of District of Columbia at 2-9. (Unless otherwise indicated, all references to comments above and hereinafter are to initial comments.)

contemplate that the Commission could or would apply a different just and reasonable standard than that underlying the 1977 benchmark prices incorporated in the NGPA as the ceiling prices for old gas.[78]

Commission Response. The Commission rejects the arguments of the opposing commenters and concludes that there is ample authority under the NGPA for the Commission's adoption of the old gas proposal. The express and unambiguous terms of the statute specifically authorize the Commission to raise old gas prices, subject only to the requirement that the Commission find that the higher rates are just and reasonable within the meaning of the NGA.

The Commission is not persuaded by the excerpts from the Senate and House debates on the NPGA cited by MPC-NASUCA [79] that Congress intended to forever keep the price of old gas at an absolute minimum. The Commission can discern no basis in the NGPA's legislative history for concluding that Congress intended to foreclose the Commission's ability to consider changes in the old gas price structure such as those proposed by DOE or to otherwise limit the Commission's authority under the NGA to establish just and reasonable rates for old gas. Indeed, the NGPA's legislative history leads to the conclusion that Congress fully understood the broad scope of Commission authority to establish regulated wellhead prices under the NGA.[80] While Congress' decision to leave old gas under the largely cost-based ceilings of NGA regulation was clearly intended to mitigate the effects of allowing higher prices for new gas, the Commission was not precluded from achieving the same result

[78] New York at 3-13.

[79] MPC-NASUCA at 3-7.

[80] *See* statements of Senators Jackson, 124 Cong. Rec. 28,633 (Sept. 11, 1978); Abourezk, 124 Cong. Rec. 30,018 (Sept. 19, 1978); and Kennedy, 124 Cong. Rec. 30,023 (Sept. 19, 1978).

by different methods, such as reliance on replacement cost and good faith renegotiation requirements as in this rule, provided the end result is just and reasonable.

The NGPA incorporated the just and reasonable rates established by the Commission in Opinion Nos. 749 and 770-A, plus an adjustment for inflation. Sections 104(b)(2) and 106(c) also provided the Commission with authority to increase maximum lawful ceiling prices above those levels if the increased prices are just and reasonable within the meaning of the NGA. The Commission may exercise this authority by rulemaking or on case-by-case basis.[81] The just and reasonable standard of the NGA is not, however, precise and rigid. The standard has been interpreted by the Commission and the courts to permit consideration of many non-cost factors in establishing just and reasonable rates.[82] These non-cost factors have included market forces, the need to stimulate production, alternative fuel prices, current exploration and development needs, and competitive conditions in wellhead markets. Factors that may be significant in determining just and reasonable rates in an era when gas supplies are scarce and competition virtually nonexistent are less significant now when those conditions are reversed. Thus, the studies presented by AGD, recalculating current ceiling prices with the methods employed by the FPC in the mid-1970's, do not necessarily establish just and reasonable price ceilings under present conditions.

MPC-NASUCA cite comments by Senator Domenici allegedly demonstrating that the NGPA was intended to preclude administrative elimination of the vintaging of old gas.[83] However, the statement on its face refers to

[81] Wisconsin Gas Co. v. FERC, 770 F.2d 1144, 1153 (D.C. Cir. 1985).

[82] *See infra* at 84-92.

[83] The statement relied on is as follows: "I am saying that [elimination of vintaging] is not in this bill, that is not doable. No one has even suggested deregulating old gas. That is what I

legislative deregulation of natural gas prices, *not* the *regulatory* revision of ceiling prices under NGPA sections 104(b) and 106(a). On April 11, 1985, Senator Domenici transmitted to the Commission a letter disavowing MPC-NASCUA's interpretation of his 1978 floor statements concerning the NGPA.[64] In his letter, Senator Domenici states as follows:

> While I did refer to "vintaging", the reference was solely in the context of stating that the legislation at hand did not remove price regulations on old gas. My reasons were as stated—the politics of the Congress in 1978 simply did not permit total deregulation. However, I did not intend—nor did Congress intend in passing the NGPA—to alter existing law with regard to the Commission's complete discretion over vintaging.
>
> It is my own belief that vintaging has been and continues to be a matter of policy for and by the Commission. That was the law under the NGA, and that was the state of the law at the time Congress adopted the NGPA. As such, the Commission is free to change it—or even terminate it—at the option of a majority of the Commissioners. Nothing in the legislative history and particularly nothing in my own statements, can be read to inhibit the Commission if it chooses to exercise that freedom in the current [RM86-3-000] proceeding.

In light of this letter and numerous cases upholding decisions of the Commission to phase-out or reinstitute vintaging, the Commission concludes that whether or to what extent vintaging should be continued and old gas

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was referring to as being not doable." 124 Cong. Rec. 28,865 (Sept. 12, 1978).

[64] The Commission has included the letter in the record of RM86-3-000.

rates revised is a matter within its discretion.[65] Thus the Commission concludes that there is no question of its authority under the NGPA to adjust old gas MLPs under the just and reasonable standards on the basis of non-cost factors, and to eliminate vintaging if circumstances so warrant. The real issue presented, therefore, is whether the Commission should exercise its authority in the manner proposed by DOE.

B. Deficiencies in Old Gas Price Structure

DOE asserts that the existing old gas price structure is "woefully outmoded,"[66] characterized by "distortions, inequities, inefficiencies and disincentives,"[67] and thus demands reform. Noting that it has been nine years since the last national ratemaking was completed, DOE argues that the economic data and information concerning replacement costs, commodity values, and other factors which were considered by the Commission in formulating the old gas prices have been overtaken by events.[68]

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[65] Shell Oil Co. v. FPC, 491 F.2d 82 (5th Cir. 1974) (FPC's decision to permit gradual phase-out of vintaging is "rational, reasonable and therefore fully permissible," Shell Oil Co. v. FPC, 520 F.2d 1061 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976) (Commission not bound by its previous policies on vintaging and has latitude to evaluate old experiments and modify or abandon them in its best judgment); Tenneco Oil Co. v. FERC, 571 F.2d 834 (5th Cir. 1978), *cert. denied*, 439 U.S. 801 (1978) (Commission's decision to reinstitute vintaging and ignore the cost of replacing flowing gas is within the Commission's discreton to balance policy considerations); Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974) (Commission could raise maximum lawful rates for old gas even without new evidence of cost of that gas in order to spread burden of cost of producing new gas to all users).

[66] DOE Notice of Proposed Rulemaking (DOE Proposal) 50 FR 48540 (Nov. 25, 1985).

[67] DOE initial comments at 2.

[68] DOE Proposal, 50 FR at 48541.

DOE's principal criticisms of the existing price structure are that it (1) results in inefficient production and the permanent loss of old gas reserves, (2) distorts the market, harming both producers and consumers, and (3) is illogical and unnecessarily complex.

On the issue of production, DOE relies on studies showing that if current old gas prices are held at their present levels, approximately 11 Tcf of old gas reserves will be permanently lost. DOE argues that domestic gas which is not produced as a result of vintaging may be replaced by foreign imports of both oil and gas that are higher in price or quality than necessary, and that the nation's energy security would thereby be compromised and the trade balance weakened.[89]

Concerning the issue of market distortion, DOE states that the Commission and the courts have recognized the inequity and discrimination between customers arising as a consequence of separately vintaged pricing for old and new gas.[90] According to DOE, this inequity has evolved as the rates for old gas were no longer able to recover a reasonable share of the cost of developing new reserves to replace the old gas being consumed. DOE reasons, however, that any presumed benefits to consumers of old gas are illusory, since their interest in secure long-term supply is not furthered, and the overall price they pay is not reduced since higher-cost gas is rolled into the pipeline's supply mix.[91]

DOE also argues that the differences between new and old gas prices as well as among old gas vintages are anomalous and excessive. Under the Permian Basin and Southern Louisiana area rate proceedings, the ratio be-

[89] *Id.* at 4; *see also*, Secretary Herrington's Comments, April 10, 1986 Hearing in Docket No. RM86-3-000, Transcript at 5-7.

[90] DOE Proposal, 50 FR at 48541, *citing* Tenneco Oil Co. v. FERC, 571 F.2d at 839.

[91] *Id.* at 48,541.

tween new and old gas ceiling prices was less than 1.2 to 1, whereas today the ratios between new gas ceiling prices under NGPA sections 102 ($4.26) and 103(b)(2) ($3.68) and ceiling prices for pre-1973 old gas ($.52) are about eight to one and seven to one respectively. The ratio between the post-1974 ceiling price of $2.57 and the pre-1973 ceiling price is approximately five to one; the ratio between current spot market prices (roughly $2.00) and the pre-1973 price is about four to one. DOE argues that these differences in prices for a fungible product such as natural gas serve no useful economic purpose.[92] DOE also argues that the existing old gas pricing system, made up of some fifteen separate old gas vintages (including minimum rate gas), is overly and unnecessarily complex as well as administratively unwieldy.

DOE recommends judging the justness and reasonableness of NGPA old gas prices on the four criteria employed by the Commission in its notice requesting supplemental comments on Part D, the block billing proposal, issued on October 9, 1985, in Docket No. RM85-1-000.[93] Under these standards, a just and reasonable rate must (1) permit efficiency in production and consumption of natural gas;[94] (2) permit fair competition;[95] (3) pre-

[92] The Permian Basin and Southern Louisiana area ratemakings established but a single rate for old gas; Opinion No. 749 (the "minimum rate" case) collapsed area rate vintages into a single national rate for flowing gas; and the first national proceeding allowed a single new gas price when old gas contracts rolled over, thereby collapsing various old gas prices into a new single price. *See id.* at 48,542, *citing* Shell Oil Co. v. FPC, 520 F.2d at 1077.

[93] 50 FR 42372 (October 18, 1985).

[94] That is, the price for natural gas in a given market should reflect the resource cost of bringing that natural gas into that market.

[95] Such competition, whether between pipelines or between a pipeline and a competing fuel supplier (such as gas, oil, coal, or electricity), should reflect the *current* decisions and efficiencies with which those suppliers operate and should not be distorted by the effects of decisions that proved to be wrong or right in past years.

vent wasteful depletion;[96] and (4) respond to changing conditions in the industry.[97] DOE concludes that current old gas prices fail to meet any of these standards and are therefore not just and reasonable.

DOE concludes that many of the problems identified by the Commission in Docket No. RM85-1-000 (Part D) result primarily from the structure of old gas prices and not from rolled-in pricing, and that those problems would be resolved by replacing vintaging with a uniform ceiling price based on replacement costs and other relevant factors. That price, according to DOE, is the ceiling price for post-1974 gas.

Comments. Producer commenters[98] and producing states[99] support DOE's position that old gas vintaging at artificially low prices is a principal cause of current market distortions. Such distortions, they say, include wide disparities in city-gate prices on different pipeline systems, the ability of pipelines to maintain above-market prices for some gas by rolling it in with low-priced old gas, and inaccurate price signals to consumers of the true replacement cost of the gas they consume. Indicated Producers and NSGA support DOE's analysis of deficiencies in the old gas price structure with their own legal and economic analyses. Indicated Producers argue that neither the Commission nor the courts have con-

[96] That is, consumers should not be encouraged to use up supplies of natural gas whose value to them is less than the cost of making those supplies available.

[97] Thus, rates for natural gas should not inhibit the growth of competition envisioned by the NGPA, and should permit, for example, the full benefits to be derived from the optional expedited certificate procedures established in Order No. 436.

[98] *See, e.g.*, NGSA at 7-22; Indicated Producers at 15-29; Independent Petroleum Association of America (IPAA) at 5; Independent Petroleum Association of Mountain States at 1-2.

[99] Interstate Oil Compact Commission at 2-4.

sidered vintaging to be an intrinsic part of just and reasonable rates under the NGA. NGSA supports its position with a comparative analysis of block billing and market pricing of old gas.[100] Process Gas Consumers Group (PGC), an association of industrial consumers of natural gas, also supports the old gas proposal as likely to reduce the market distortions arising from remaining wellhead price controls as does the Fertilizer Institute, representing agricultural consumers.[101]

Pipeline and distributor commenters, as well as certain state commissions argue that the proposed rule erroneously targets old gas prices as economically inefficient and a source of market disorder. Interstate Natural Gas Association of America (INGAA), for example, disagrees with DOE's analysis and argues that the proposed rule would do nothing to address the "overarching" problem of high-price/high-take contracts and that the DOE proposal "increases the likelihood of market distortions, since the high-price/high-take contract problems can be expected to worsen," if old gas prices are permitted to increase.[102]

Other opposing commenters assert that there is no factual evidence of any market distortion attributable to old gas vintaging, or that market distortions, which may have existed in the past, are no longer present. United Distribution Companies (UDC), for example, states that

[100] This study, prepared by Prof. Joseph P. Kalt of Howard University, discusses the distorting effects of below-market pricing and how this creates a cushion to subsidize the otherwise uneconomic development of high-cost gas. Professor Kalt argues that vintage pricing inhibits development of low-cost supply sources and stimulates prematurely higher-cost supply development, and that the benefits of the existing structure accrue chiefly to high-cost gas producers and not to the consuming public as a whole.

[101] PGC at 3. PGC finds a shortcoming in DOE's proposal, however, in that it does not link increases in old gas prices to reductions in high-priced new gas.

[102] INGAA at 4-5.

while DOE alleges there are market distortions caused by the current pricing structure applicable to old gas, the "specific factual bases for these contentions are not identified . . ." [103]

Commission Response. Upon consideration of all of the comments and views with regard to alleged deficiencies in the old gas structure, the Commission concludes that serious distortions remain in the natural gas markets and that these distortions emanate primarily from the old gas vintage price structure. This is not a new insight. Beginning with the Notice of Inquiry in Docket No. RM82-26-000, and more recently in the Docket No. RM85-1-000 (Part D) proceedings, the Commission has grappled with the problems arising out of the old gas price structure, either directly or indirectly. The Commission has long recognized distortions and deficiencies in the old gas pricing system. Thus, the DOE proposal is the culmination of a long period of Commission review of the problem of the old gas price structure in prior proceedings.

In Docket No. RM82-26-000, for example, the Commission issued its notice of inquiry on the impact of the NGPA on current and projected natural gas markets.[104] The central purpose of the notice of inquiry was to gather information on the existence of market distortions due to rolled-in pricing of old and new gas supplies and to study recommendations that the Commission revise the prices of old flowing gas to eliminate the distortions.[105] More

[103] UDC at 3.

[104] 47 FR 19157 (May 4, 1982).

[105] In its Notice of Inquiry, at Appendix A, Docket No. RM82-26-000, the Commission noted two reasons why the elimination of vintaging may be appropriate: (1) "[T]he elimination of vintaging may be appropriate because, combined with partial decontrol, it may be a major factor exacerbating the market ordering problem." * * * (2) "[V]intaging may discriminate unreasonably against customers of pipelines that have a much smaller price cushion. . . . This advantage is the result of a pipeline's historical,

recently, in the block billing proposal in Docket No. RM85-1-000 (Part D),[106] the Commission proposed to remedy the continuing market imbalances but only indirectly, without affecting the root cause of these imbalances—the old gas pricing structure.[107] The record in the present proceeding confirms the inadequacy of the old gas price structure, and the continuing necessity to act on it. For example, the price disparities engendered by it have led to the continued failure since the NGPA to achieve replacement of reserves equivalent to demand, as would occur in an economically rational market.[108] Also, the old gas cushion has failed to keep burner tip prices competitive with oil. Rather, as the wellhead price of gas has rapidly plummeted to remain competitive, city-

fortuitous opportunities to contract for large volumes of low-priced vintaged gas and bears no rational relationship to its customers' demands or priority uses." FERC Stats. and Regs. ¶ 35,512, at 35,574. Thus the DOE old gas proposal was presaged almost exactly by the Commission in the Notice of Inquiry.

[106] 50 FR 42408 (October 18, 1985); 50 FR 45,907 (November 5, 1985).

[107] The block billing approach eschewed adjustment of the old vintages, partly as a result of an implicit narrow reading of the Commission's authority to set just and reasonable rates under NGPA sections 104(b)(2) and 106(c). Analysis of the DOE proposal and the comments generated by it leads the Commission to conclude that its discretion under sections 104 and 106 is wide enough to allow the Commission to collapse the old gas vintages, thereby directly attacking the source of distortions. As has been pointed out, Congress in Title I intended to treat gas producers as a naturally competitive sector, and the DOE proposal permits market forces to work in that competitive sector on old gas, while keeping within the bounds of a price ceiling circumscribed by the just and reasonable replacement cost of the commodity. *See, e.g.*, Pennzoil Co. v. FERC, 645 F.2d 360, 378-79 (5th Cir. 1981) ("Congress apparently decided that gas producers do not have 'natural' monopoly power") *cert. denied*, 454 U.S. 142 (1982); *see also* NGSA at 9-12.

[108] *See e.g.* Initial Comments of AGA, Appendix B, "AGA-TERA BASE CASE 1986-I" (AGA projects under current well-

gate rates have declined with disproportionate slowness, due in large part to the favorable access of some consumers to artificially low-priced old gas, compared to other not so fortunate consumers.[109]

We note the contention that the distorting effect of old gas prices has been dissipated. Maryland People's Counsel (MPC) for example, argues that market distortions caused by the old gas cushion are now largely dissipated, since any original advantage attributable to cushion gas has now been "used up" and prices of new gas coming on the market are now fully subject to the discipline of the marketplace.[110] Texas Gas Transmission Corporation (Texas Gas) also asserts that low prices of NGPA sections 104 and 106(a) gas are no longer skewing purchasing decisions. While agreeing that market disorders arising from the past contracting practices remain, Texas Gas argues that the remedy should be directed to the high-cost "problem" contracts rather than old gas prices. It is true that the bidding wars of the 1978-1981 period

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head prices, that "the combined effect of falling discoveries and more stable extensions and revisions is a reduction in the level of total reserve additions of 41 per cent between 1985 and 2000.").

[109] The high city-gate rates have vintaging as a "root cause", because the high-cost contracts that are indirectly contributing to these rates were entered into when pipelines relied on the misleading economic signals intrinsic in the unrealistically low old gas cushion vintages to which they had access.

[110] What MPC is referring to is the "bidding war" by pipelines during the 1978-81 period of relative supply scarcity. Anxious to attach additional reserves to replenish inventories severely depleted during the curtailment era, pipelines paid maximum lawful prices for new gas and contracted for deregulated supplies at prices as high as $8-$10 per MMBtu. Those pipelines with larger cushions of old gas vintages were able to outbid their competitors, not on the basis of efficiency of operation and management, but solely based on the amount of "old" gas they could roll-in without adversely affecting their weighed average cost of gas (WACOG) vis-a-vis other pipelines. After 1982, most pipelines added market-out clauses in new cointracts to make them market-responsive.

are over, and that prices for new supplies on the spot market have fallen well below the levels experienced during that period and, indeed, below the highest old gas ceiling price (post-1974 vintage). But, while the bidding-up of prices for new gas, (caused in large part by reliance by purchasers on their old gas cushions) may have ended, the distorting effects of the artificially low prices established by the vintage price system remain. Once the present deliverability surplus [111] is eliminated and natural gas supply and demand come into balance,[112] new gas prices could potentially be required to bear the brunt of price increases permitted by the market, resulting in disproportionate increases in new gas prices and increased distortion in the overall price structure as between old and new gas. If vintaging is not eliminated now, the price distortions it causes will be aggravated when the surplus disappears and bidding on new gas supplies accelerates.

Because NGPA sections 104(b)(2) and 106(c) expressly authorize the revision of old gas ceiling prices, the Commission need not find existing old gas price ceilings unjust and unreasonable under the NGA in order to change them. However, insofar as the existing old gas price structure *is* unjust and unreasonable within the meaning of the NGA, because of the continuing distortions on prices and reserve replacement it engenders, it

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[111] The Commission has recognized a surplus of gas available for delivery amounting to between 1 and 4 Tcf or an annual basis. Notice Requesting Supplemental comments, RM85-1-000 (Part D) 50 *Fed. Reg.* at 42,383; AGA estimates excess production capacity at between 2.5 and 2.8 Tcf in 1986. AGA, Appendix A, at 3.

[112] DOE estimates that under its old gas proposal, surplus deliverability will be reduced to between 1-2 Tcf at the end of 1986, and will be totally dissipated during 1987. Without adoption of its proposal, the surplus will not be dissipated until 1989, at which time, if vintages persist, bidding up of deregulated gas may be renewed and drilling budgets inefficiently allocated to those marginal supply prospects with the highest per unit price, rather than those with the highest value in terms of additions to reserves. DOE at 13.

must be changed pursuant to the authority vested in the Commission by Congress.[113] There is no legislative mandate for permanent vintaging. The history of vintage pricing supports this conclusion. The history of vintaging in producer regulation under the NGA commenced with the original Statement of General Policy No. 61-1,[114] in which the Federal Power Commission (FPC) outlined its plan for establishing area rates. In the Statement of General Policy No. 61-1, the FPC, while establishing separate schedules for initial prices in new contracts and increased prices in existing contract, stated that "[i]t is anticipated that these differences in price levels will be reduced and eventually eliminated as subsequent experience brings about revisions in the prices in the various areas." [115] The Commission subsequently acted to eliminate vintaging in Opinion No. 639 (Appalachian Area Rate Proceeding) stating that "[w]e believe vintaging to be an anachronism which we should now move to eliminate," [116] and Opinion No. 699-H [117] (first nationwide rate proceeding), and these decisions were affirmed by the Courts.[118] Vintaging was subsequently reestablished by the Commission in Opinion Nos. 770 and 770-A and has remained in effect since then.

Since vintaging is the major cause of the market distortions identified by the Commission in Docket No.

[113] *See* Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985).

[114] 24 FPC 818 (1960).

[115] *Id.* at 819.

[116] 48 FPC 1299, at p. 1309 (1972).

[117] 52 FPC 1604 (1974). *See also*, Opinion No. 749, 54 FPC 3090 (1975).

[118] Opinion No. 699-H, *aff'd sub nom. Shell Oil Co. v. FPC*, 520 F.2d 1061 (1975), *cert. denied sub nom. California Co. v. FPC*, 426 U.S. 941 (1976); Opinion No. 749, *aff'd sub nom. Tenneco Oil Co. v. FERC*, 571 F.2d 834 (1978), *cert. dismissed*, 439 U.S. 801 (1978).

RM85-1-000, the current problems being experienced in natural gas markets would largely be remedied by collapsing vintages and raising ceiling prices of below-market priced gas. The elimination of vintages, as necessitated by market trends, is not a total departure from past practice. Congress' grant to the Commission in sections 104(b)(2) and 106(c) allowing increased ceiling prices to be established if just and reasonable must be understood in this historical context.

The evidence in this proceeding demonstrates that existing old gas prices prevent fair competition because pipelines and distributors with proportionately greater access to low-priced old gas are placed in an advantageous competitive position in acquiring and marketing supplies relative to those pipelines and distributors with less access to cushion gas. MPC has argued that the unfair advantage given certain pipelines by their old gas cushion has been expended through the process of bidding-up the price of deregulated gas. However, the old gas cushion *continues* to distort downstream markets by providing an unfair competitive advantage to some pipelines.[119] The field WACOGS of interstate pipelines continue to be related to the size of their old gas cushions.[120] Indicated Producers provide a relatively detailed analysis of the impact of the old gas cushion on pipelines' competitive positions that rebuts MPC's argument.

Indicated Producers' analysis includes an index to measure a company's relative old gas cushion by accounting for both the old gas percentage of its total field purchases and the average price paid for old gas. The index is computed by dividing the old gas percentage by the old gas price for each pipeline and then dividing this

[119] *See* Indicated Producers reply comments at 16-20, rebutting MPC comments at 14-15.

[120] *See* Indicated Producers reply comments, Appendix E at 18, chart 2.

number into the composite index of 100 for the 24 pipelines. Thus, a pipeline with a cushion index of 182, would have twice the old gas cushion as a pipeline with an index of 91. This index system demonstrates the wide differences in old gas cushions among interstate pipelines, with the largest cushion (Northwest Central's) 8.8 times greater than the smallest cushion (of Florida Gas).

More importantly, these data, based on information in the Commission's public files, illustrate the distorting impact the old gas cushion has on pipelines' competitive positions. An excerpt from Indicated Producer's tabulation, (derived from PGA filings in effect as of January 1, 1986), shows the following: [121]

		Old Gas		*New Gas*		
Pipeline	*Cushion Index*	*Bcf*	*Price*	*Bcf*	*Price*	*(WACOG) Average Price*
Northwest Central	251.1	198	$0.85	102	$3.79	$1.82
Colorado Interstate	182.2	99	0.87	103	2.98	1.95
Texas Eastern	154.0	229	0.72	438	2.85	2.12
El Paso Natural	100.0	322	1.27	497	3.20	2.44
Southern Natural	97.4	141	1.39	196	3.95	2.88
Transwestern	79.6	54	1.20	129	3.19	2.60
Columbia Gas	56.6	162	1.58	424	3.64	3.07
Transcontinental	53.1	141	1.63	387	3.58	3.06
Consolidated Gas	40.3	20	1.00	123	3.80	3.41

As can be seen, El Paso and Transwestern have a 16¢ spread in WACOG even though they serve the same market and pay virtually the same price for new gas. Similarly, Southern Natural enjoys an 18¢ competitive advantage in WACOG over Transco, and can still afford to pay more for new gas than Transco. This competitive advantage has little to do with current or just operating efficiencies or any other fair measure of competition.

[121] *Id.* at 19, Table 5.

Instead, the advantage may be traced in substantial part to Southern Natural's old gas cushion index which is nearly twice as large as Transco's.

Since the pipeline's WACOG substantially affects the city-gate rates, the ultimate consumer feels the distorting effect of old gas vintages. While some consumers will pay less than the replacement cost of their gas, many more will find prices stubbornly higher than they would be if competitive forces in the field were allowed to operate at the burner-tip.

Thus the old gas price structure has become a structural source of market distortion and unfair competition since it engenders widely varying prices based on chance historical costs for a fungible commodity produced and sold in an otherwise competitive market. In reviewing the Commission's determination of area rates for the Southern Louisiana area, the court in *Placid Oil Co. v. FPC*, 483 F.2d 880, 899-900 (5th Cir. 1973) stated that:

> Natural gas is a fungible commodity as it comes from the bowels of the earth, neither severed nor identified to a particular contract. One molecule of gas flowing from a particular producer's wells in [the Southern Louisiana Area] might be ultimately piped to a large industrial factory pursuant to a 1962 contract, which under the terms of Opinion No. 598 would permit a maximum well-head price of 22.375¢/Mcf. At the same time its identical contiguous twin might cook the dinner for the famed 'little lady at the burner-tip' and, yet, yield a well-head price of 26¢/Mcf merely because it happened to be covered by a 1969 contract. It is therefore anomalous, if not downright inaccurate, to speak of 'old' gas. There is no 'old' gas. As it presses to freedom at the well-head, it is as 'new' as any other of nature's offspring. It may be 'old' in the sense that some arrangement confected long prior to its release made production possible. But if—and this can be

no if—rates for so-called 'new' gas must carry an increment to enable the continued re-supply of this depleting commodity, this 'old' gas, indistinguishable molecularly, must carry this burden like an added atom in its carbon ring. *Cf. Ziegler v. Phillips Petroleum Co.*, (5th Cir. 1973), 483 F.2d 858.

This is exactly the Commission's view.

The Commission fully recognizes that the old gas price system is not the sole source of the problems facing the natural gas industry at this time, and that numerous commenters argue that the current problems in the natural gas market are caused primarily by non-market responsive new gas contracts. AGA, for example, states that "the DOE proposal is attacking the wrong problem. That problem, as we have said time and time again, is non-market-responsive new gas contracts."[122] Texas Gas, another example of such commenters, argues that the proposed rule will result in an increase in average gas prices and further loss of sales because of rigidities in high-cost new gas contracts. Yet Texas Gas implicitly acknowledges that collapsing vintaging will stimulate recovery of additional old gas reserves but argues this

[122] AGA at 2; *but see* AGA's endorsement of legislation deregulating old gas upon contract renegotiation or expiration p. 38, *supra*, at n.65. AGD endorses AGA's identification of non-market responsive contracts as the principal source of market disorder. *See also* ANR Pipeline Company at 2; Consumer Power Company and Michigan Gas Storage Company at 4-5; California PUC at 24; Florida Gas Transmission Company at 7; Kansas Power and Light Company at 15-16; Michigan Consolidated Gas Company at 21-22; Midwest Energy, Inc. at 4; Northern Illinois Gas Company at 18-19; Peoples Gas Light and Coke Company and North Shore Gas Company at 23; Piedmont Natural Gas Company, Inc. at 7; Questar Corporation at 7; Transwestern Pipeline Company at 7; Southern California Gas Company at 22.

additional supply is not needed now in light of current oversupply conditions.[123]

Of course, many factors have contributed to the current situation, characterized by falling wellhead market prices, unresponsive city-gate prices, fuel switching, loss of loads, and excess production and transmission capacity. Among the causes of present industry conditions is the unexpected decline in world oil prices and the related decline in prices of competing fuels derived from oil, notably, No. 6 fuel oil. The Commission is also keenly aware of the problems attributable to non-market responsive new gas contracts on pipeline systems.[124] The Commission nevertheless must reject the arguments of certain parties that any change in the old gas price structure be made subject to or conditioned upon some form of relief to purchasers from the terms of their uneconomic contracts. Such general intervention into private contractual arrangements has not been proven necessary. On the contrary, data indicate that many of these contractual difficulties are being settled by negotiation between the parties involved. (*See* discussion *infra*, pp. 147-49).

Yet the Commission can, and must, address the problems related to the old gas vintages. In this way the market itself will exert pressure on contracts outside of the ambit of the Commission's direct jurisdiction, to lessen the "spread" between high-cost contract prices and actual market prices. The Commission has addressed the question of uneconomic contracts for new gas and has provided a framework under Order No. 436's expedited

[123] *See e.g.*, MPC-NASCUA at 16, ANR Pipeline Co. at 2-3, Public Utilities Commission of the State of California at 24 and Appendix, Public Service Co. of Colorado at 6-7.

[124] *See* discussion, *infra* at pp. 146, 156-57 regarding price disparity between pre-1982 and post-1982 new and high-cost gas contracts.

abandonment procedure and the April 1985 "Take or Pay Statement of Policy" for the resolution of this problem.

The Commission believes that the natural forces of competition will resolve the issues surrounding high cost contracts. The Commission notes that substantial competition already exists at the burner-tip, and the open access to alternative supplies made available through Order No. 436 can only result in increased competitive pressure on gas prices in the future. The Commission has previously stated and reaffirms its position that problem contracts are primarily a matter for resolution between the parties involved.[125] The Commission has adopted a policy statement issued April 10, 1985, designed to facilitate that process.[126] For largely the same reasons expressed in Order Nos. 436 and affirmed in 436-A,[127] the Commission declines to go beyond the April 1985 policy statement, and has confidence that the free operation of market forces will provide a resolution of this issue.[128]

[125] *See* Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Docket No. RM85-1-000, 50 Fed. Reg. 42,408, at 42,462-64 (Oct. 18, 1985); Order No. 436-A, 50 Fed. Reg. 52,217 (Dec. 23, 1985).

[126] Regulatory Treatment of Payment Made in Lieu of Take-or-Pay Obligations, Docket No. PL85-1-000, Statement of Policy and Interpretive Rule, 50 Fed. Reg. 16,076 (April 24, 1985), FERC Stats and Regs. ¶ 30,637 (1985).

[127] "In particular, we have no wish to upset current renegotiations. . . . Therefore, . . . we reaffirm our April 1985 Policy Statement . . . We note that pipelines have been successful in buying out past incurred take-or-pay in a number of instances. [Table omitted]." Order No. 436, 50 FR, at 42464 (October 18, 1985).

[128] *See e.g.*, the "released" gas programs undertaken by many pipelines, where their takes of system supply gas are low and where their takes temporarily released from high-cost contracts with renegotiated prices ("released gas") are extremely high. For example, Southern Natural Gas Company has applied to the Commission to release certain gas under contract between it and various producers, Docket No. CP86-277-000. The parties to the contract have agreed to release each other from their respective gas sales and purchase obligations so that the suppliers can sell the released gas to a marketing affiliate of Southern. The suppliers will credit all released gas that is sold to the marketing affiliate toward satisfying Southern's take-or-pay obligations.

In sum, the record in this proceeding demonstrates that the old gas price structure is a substantial source of market distortion causing producers to prematurely abandon easily accessible supplies, and consumers to react to misleading market signals based on chance historical costs rather than current economic efficiencies. The Commission therefore concludes that the old gas price structure is unjust and unreasonable and should be changed.

C. Proposed Old Gas Ceiling Price.

DOE proposes that the Commission establish a uniform ceiling price for old gas equal to the current price for post-1974 vintage gas and that once established that price continue to be adjusted for inflation as provided for in NGPA section 104. DOE describes the proposed ceiling price as being based on two factors, the first being the ceiling price established in Opinion No. 770 for post-1974 gas and the second being the inflation adjustment factor incorporated in the NGPA and used to adjust that price monthly for inflation commencing in April 1977.[129] DOE argues that the Commission is obliged to establish a rate which is within a "zone of reasonableness" and that this zone may be established by reference to both cost and non-cost factors as well as policy considerations.[130] DOE argues that the zone of reasonableness can expand in accordance with factors such as replacement costs, prices of alternative fuels, and competition.[131]

[129] DOE initial comments at 26.

[130] DOE Proposal, 50 FR 48541 (November 25, 1985). *See FPC v. Conway*, 436 U.S. 271 (1976).

[131] DOE Proposal, 50 FR 48541.

DOE states that it has developed a "Two-Market Model" to analyze the natural gas market, and that the model "utilizes information on natural gas replacement costs, alternative fuel prices and wellhead price regulations to calculate market price and quantity projections for natural gas." [132] DOE states that it has used the Two-Market model to estimate that a just and reasonable price would be between $2.44 per Mcf and $2.68 per Mcf assuming oil prices of approximately $22 per barrel "in real terms from 1986 through 1990." [133] According to DOE, the model relies on replacement costs and other factors including supply, reserve and demand estimates, production-to-reserves ratios, and gas transmission and distribution costs.[134] DOE's actual price recommendation is based primarily on replacement costs with additional weight being given to current commodity values of unregulated gas supplies and alternative energy sources including No. 2 distillate, No. 6 fuel oil and crude oil.[135]

Comments. Producer commenters support the post-1974 ceiling price as being just and reasonable based on both cost and non-cost factors and consistent with prior producer rate decisions of the Commission and relevant judicial precedent. Indicated Producers argue that the Opinion No. 770 replacement cost methodology fully supports the justness and reasonableness of the proposed ceiling price. They also submit that replacement cost is the only relevant cost in a competitive industry and that the Commission has previously recognized this fact by providing in the first national rate proceeding (Opinion No. 699-H) for the uniform pricing of natural gas at the level of replacement cost. Indicated Producers further support the justness and reasonableness of the post-1974 rate

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[132] DOE at 28.

[133] *Id.* at 28-29.

[134] *Id.* at 29-36.

[135] *Id.* at 36-41, n.33.

based on the consideration of various non-cost factors including supply response, commodity value estimates, and the alleged favorable impact the proposed ceiling price would have on all segments of the gas industry including consumers.[136] NGSA supports the proposed ceiling price primarily on the basis of its predicted beneficial effects rather than by reference to specific cost considerations. PGC supports the post-1974 price as being administratively efficient, rationally calculated to reduce market disorders, and properly based on cost and non-cost factors.[137]

Pipeline, distributor and consumer commenters object strongly to the pricing of all old gas at the post-1974 ceiling price. A number of commenters oppose DOE's ceiling price recommendation as being based primarily or exclusively on non-cost factors.[138] AGA, for example argues that DOE's proposal to establish a uniform ceiling price ignores the history of cost differences based on vintages and would improperly rely on market forces to determine the actual price under particular contracts as a result of the good faith negotiation rule.[139] UDC likewise argues that the proposed ceiling price lacks adequate cost support. UDC alleges that the proposed rule fails

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[136] Indicated Producers at 49-53.

[137] PGC at 6.

[138] *See e.g.,* AGA at 15-24; American Public Gas Association (APGA) at 41-44; UDC petition for dismissal (February 10, 1986), Appendix A at 3-11; Peoples Gas Light and Coke Company and North Shore Gas Company (joint comments) at 10-13; Michigan Consolidated Gas Company at 620; Rochester Gas and Electric Corporation at 16-20; Southern California Gas Company at 1-12; Southwest Gas Company at 18; Southern Illinois Gas Company at 1-12; Southern Gas Corporation at 3-5; Columbia Gas Distribution Companies at 2-4; Laclede Gas Company at 6-11; Northern Distributor Group at 6-8; Piedmont Natural Gas Company at 3-7; New York at 3-13; California PUC at 5-12; Arkansas PSC at 4; PSC of Wisconsin at 2-5; PSC of West Virginia at 6-9; PSC of Kentucky at 1-4; PSC of District of Columbia at 2-9.

[139] AGA at 21.

to acknowledge cost as being a necessary foundation for just and reasonable rates and criticizes DOE for failing to consider numerous Commission and judicial precedents holding that costs are a necessary foundation from which a determination of rates must proceed.[140] UDC complains that the proposed rule is based on arguments designed to establish the Commission's authority to base rates on such non-cost factors as "competition, supply, demand, reserves and industry structure." [141] Similarly, Peoples Gas Light and Coke Company and North Shore Gas Company interpret the proposed rule as premised on the assumption that cost may be ignored in establishing just and reasonable rates. They argue that while non-cost factors may be considered, costs must be given primary consideration, and that the Supreme Court has held that in setting rates the Commission lacks authority to place exclusive reliance on market prices.[142] Similar arguments are made by pipelines. INGAA, for example, argues that the proposed rule, "by not even considering the cost data required under the NGA is asking the Commission to exercise powers beyond its authority." [143] Tennessee Gas Pipeline argues that although the courts have approved the use of non-cost factors in conjunction with costs to achieve relevant regulatory purposes, the courts have rejected the idea that just and reasonable rates can be based solely on "non-cost, market factors." [144] Natural Gas Pipeline Company of America argues the proposed rule improperly ignores costs and is instead based on arbitrary rates which "merely allow old gas prices to in-

[140] UDC petition for dismissal (February 10, 1986) Appendix A at 4.

[141] *Id.*

[142] *Peoples Gas Light* at 11-12, *citing FPC v. Texaco*, 417 U.S. 380 (1974).

[143] INGAA at 10.

[144] *Tennessee Gas Pipeline* at 11, *citing FPC v. Texaco*, 417 U.S. 380 (1974).

crease, based solely on market or commodity value factors." [145] Many commenters also argue that the just and reasonable rate for the various old gas vintages must be determined strictly on the basis of historical as opposed to replacement costs.[146] These commenters argue that to the extent the proposed ceiling price exceeds the price which would result from application of prior, Commission-approved historical cost methodologies, it is unjust and unreasonable within the meaning of the NGA and therefore cannot lawfully be adopted.

In its December 20, 1985, notice of procedural schedule, the Commission requested comments concerning alternative methodologies by which just and reasonable rates could be determined in light of contemporary market needs and conditions. In response the United States Department of Justice (DOJ) submitted an alternative old gas price proposal together with supporting comments. DOJ argues that in light of the fact that the natural gas producing industry is competitive, there is no longer any reason or need to continue using costs as a basis for determining just and reasonable rates and recommends that the Commission adopt a rule providing that any price paid for natural gas subject to sections 104, 106(a) and 109 of the NGPA be presumed to be just and reasonable. According to DOJ, the courts have held that the Commission has broad discretion in adopting particular methods of regulation and that it is the "end result" which controls, citing *Hope*. DOJ argues that the proper tests of a just and reasonable rate are (1) does it protect consumers against excessive charges and (2) is it

[145] Natural Gas Pipeline at 25.

[146] UDC reply comments at 26-41; APGA reply comments at 20-41; AGD reply comments at 6-10, Appendix A; AGA reply comments at 7-9; MPC-NASUCA reply comments at 9-10; Southern California Gas Company reply comments at 10; Panhandle Eastern Pipe Line Company and Trunkline Gas Company reply comments at 4-5; Peoples Gas Light and Coke Company and North Shore Gas Company reply comments at 14-17.

consistent with the maintenance of adequate and reliable service.[147] DOJ reasons that since the natural gas market is effectively competitive, market-based rates satisfy the stated criteria.

Commission Response. The just and reasonable rate standard is set forth in sections 4 and 5 of the Natural Gas Act of 1938. In 1954, the Supreme Court held in the seminal decision in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), that the Commission has authority under the NGA to regulate the wellhead price of natural gas. Following *Phillips*, the Commission first attempted to regulate rates on a producer-by-producer basis but abandoned this approach as administratively infeasible and moved to determine rates on an area-wide basis. The first area rate case resulted in the landmark *Permian Basin* decision, Opinion No. 468, 34 FPC 159 (1965), which was affirmed by the Supreme Court.[148] In *Permian* the Commission established separate prices for "new" and "flowing" (old) gas. The price for new gas was based on current costs while the price for old gas was based on historical costs. Commencing in 1974, the Commission established producer rates on a national rather than area-wide basis.[149]

In determining just and reasonable producer rates under the NGA, the Commission has consistently relied primarily on costs while also considering relevant non-cost factors. Courts reviewing the Commission's decisions have generally affirmed the Commission's selection of particular cost methodologies and rate structures as being permitted by the reasonable exercise of the Commission's discretion.[150] Notably, the courts have not mandated the

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[147] DOJ at 14. *See Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975).

[148] *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

[149] Opinion No. 699-H and Opinion Nos. 770 and 770-A, *supra*.

[150] Opinion No. 699-H, *aff'd Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975), *cert. denied* 435 U.S. 907 (1978); Opinion No.

use of historical cost methodologies and have affirmed the Commission's use of replacement cost as a proper basis for establishing just and reasonable rates.[151]

There is much controversy reflected in the comments concerning the extent to which the Commission can or should rely on non-cost factors in determining just and reasonable rates. It will be helpful at this point to clarify the issue of reliance on cost versus non-cost factors in evaluating the lawfulness under the NGA of DOE's proposed ceiling price. The rate proposed by DOE has its source in Opinion No. 770, 56 FPC 509, 560-75 (1976). The FPC there established the post-1974 rate at $1.42 per Mcf based on the midpoint of a zone of reasonableness defined by prices derived from two separate estimates of productivity of drilling and the use of two separate DCF cost models. 56 FPC at 567. The price included a four cent per Mcf annual escalation designed to assure a constant rate of return and thereby assure that the price remained representative of the cost of finding and producing natural gas in the future. The price, in other words, represented the replacement cost of gas.[152] The FPC went on at length to consider a number of non-cost factors to ensure that the "end result" was just and reasonable as required by *FPC v. Hope Natural Gas Co. supra.* Non-cost factors considered by the FPC included intrastate market prices, commodity value, and economic impact. 56 FPC at 578-86. However, the FPC did not make any adjustments whatever to the cost-based rate of

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749, *aff'd Tenneco Oil Co. v. FERC*, 571 F.2d 834 (5th Cir. 1978), *cert. denied* 439 U.S. 801 (1978); Opinion Nos. 770 and 770-A, *aff'd American Public Gas Association v. FPC*, 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied* 435 U.S. 907 (1978). *See, also Placid Oil Co. v. FPC*, 483 F.2d 880 (5th Cir. 1973), *aff'd, Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974); In re *Permian*, 390 U.S. 747 (1968).

[151] *Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975).

[152] 56 FPC at 521.

$1.42 per Mcf based on its consideration of non-cost factors, and used its consideration of such factors solely as a means of verifying or confirming the justness and reasonablenes of the purely replacement cost-based rate.[153] That rate was escalated at the rate of one cent per quarter (four cents per annum) until enactment of the NGPA, and since that time the then-effective rate has been adjusted pursuant to the NGPA's inflation adjustment factor rather than the quarterly adjustment provided for in Opinion No. 770. The rate resulting from this process is the current post-1974 ceiling price of $2.57 per MMBtu as of June 1986.

As a consequence of the adjustment-for-inflation feature of the NGPA it is reasonable to assume the current post-1974 vintage price remains representative of replacement costs, absent a showing that changes in the cost of finding and producing gas have been significantly more or less than average inflation in the economy as a whole. The record demonstrates that the post-1974 price remains reasonably representative of current replacement costs. Indicated Producers provide a study estimating the 1985 replacement cost of gas based on a recalculation of the Opinion No. 770 discounted cash flow (DCF) cost model using current costs and updated values for such items as rate of return, federal income taxes, investment tax credits, and working capital.[154] The result of this calculation is a current replacement cost of $2.77 per MMBtu. Since the ceiling price is a purely replacement cost-based rate and does not include any allowance for non-cost factors, it is unnecessary in evaluating the reasonableness of the proposed ceiling price to consider the extent to which the Commission could or should base the ceiling price for old gas on non-cost factors. The question presented is straightforward and simple, namely, is the proposed uniform ceiling price for old gas, based on replacement cost, just and reasonable within the meaning of the NGA? For the reasons hereinafter discussed, we conclude that it is.

[153] 56 FPC at 515; *APGA v. FPC, supra*, 567 F.2d at 1030.

[154] Indicated Producers, Appendix A.

The just and reasonable rate standard has never been interpreted to require that rates be based on historical or original cost. As early as 1945, Justice Jackson, concurring in *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581 (1945), a case involving the justness and reasonableness of pipeline rates established under the NGA, stated that "farsighted gas rate regulation will concern itself with the present and future, rather than with the past, as the rate base formula does." 324 U.S. at 612. More recently, in affirming the Commission's establishment in Opinion No. 749 of a uniform price for flowing gas, the Fifth Circuit stated that "the choice between actual cost and replacement cost is for the Commission to make, subject to the sole requirement that the end result be within the 'zone of reasonableness.'" *Tenneco Oil Co. v. FERC*, *supra*, 571 F.2d at 840.[155] The Supreme Court has recognized that gas producers are not typical public utilities. Justice Harlan, speaking for the Supreme Court in *Permian*, stated that "Producers of natural gas cannot usefully be classified as public utilities. They enjoy no franchises or guaranteed areas of service. They are intensely competitive vendors of a wasting commodity they have acquired only by costly and often unrewarded

[155] The old gas ceiling price established in Opinion No. 749 was 29.5 cents per Mcf. The Tenneco court commented on the disparity between this rate and the then-effective new gas price of $1.42 per Mcf as follows: "Complicating the Commission's attempts to resolve this difficult balance [between producers and consumers] is the *gargantuan inequity* that results when some consumers, merely because they contracted first, get natural gas at a price which is less than one-fifth of the price that other consumers pay for natural gas or any other comparable energy source." 571 F.2d at 839 (emphasis added).

search. Their unit costs may rise or decline with the vagaries of fortune." [156]

It is beyond doubt that producers must, on average, and over the long run, receive revenues for sales of gas which are sufficient to encourage and enable them to explore for and develop new reserves needed to replace those being consumed. Only in this way can there be any reasonable assurance that natural gas will be available in quantities sufficient to provide adequate and reliable service to current as well as future generations of consumers. Under the existing old gas price structure, many categories of old gas are frozen at prices well below replacement costs as well as below current market prices, which are themselves well below replacement costs. Where prices for a substantial portion of natural gas are regulated at prices substantially below (and in some cases only a fraction of) current market prices, and where the remainder of the market is unregulated, it is inevitable that the price of the unregulated supply will, over time, increase disproportionately relative to the market price, such that the average price realized by producers is at least equal to the market price. The result is an extreme difference between regulated and unregulated prices. This fact accounts for the wide disparity which occurred in the price structure of natural gas both as between interstate and intrastate prices and among vintages of old gas prior to enactment of the NGPA, and as between old gas and new gas under the NGPA. The pricing of old gas at below-market prices has led, in principal part, to prices being realized by producers for new and deregulated gas under the NGPA which are far in excess of market prices and which are a prime cause of dysfunction in today's natural gas market.

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[156] *Permian*, 390 U.S. at 756-57 (footnote omitted). *See also Southern Louisiana Area Rate Cases*, 428 F.2d 407 at 634 (5th Cir. 1970).

The Commission has previously determined that natural gas ceiling prices should be established at a uniform level based on replacement costs. In the first national rate proceeding, Opinion No. 699-H, the Commission established a rate for new gas based on current replacement costs and provided that producers selling gas under expiring contracts would be entitled to the new gas ceiling price upon negotiation of renewal contracts with their purchasers. Opinion No. 699-H, 52 FPC at 1631-32. The effect of this decision would have been to eliminate vintaging gradually as old contracts expired and were renegotiated with the result that all categories of gas would ultimately be priced at the new gas ceiling price based on replacement costs or at current market prices, whichever is lower. Furthermore, the Commission held that all gas which initially qualified for the new gas ceiling price would be entitled to the ceiling prices determined in succeeding national rate proceedings. 52 FPC at 1636. In explaining its actions in Opinion No. 699-H, the Commission stated as follows (52 FPC at 1637):

> The adjustment of all rates for post-December 31, 1972, dedications to the newly established rate will also over an extended period of time result in a uniform base price for gas sold in interstate commerce, which equates to the cost of replacing the unit of gas consumed. This uniform price will constitute a recognition of the fact that gas is a consumable irreplacable commodity and not a service which can be renewed by man. (footnote omitted).

Opinion No. 699-H was upheld on judicial review in *Shell Oil Co. v. FPC, supra*. In affirming the Commission, the court in *Shell* stated as follows (520 F.2d at 1076-77):

> The practical result of allowing flowing or "old" gas to be sold at the new national rate upon expiration or renegotiation of preexisting contracts is that the former "vintaging" of gas according to its period

of discovery will gradually disappear. The Commission is not bound by its previous policies. As this Court and the Supreme Court have noted on various occasions, the rate structures which introduced or adjusted vintaging were experimental. It is necessary without a doubt that agencies be permitted latitude to evaluate old experiments and modify or abandon them when their best judgment requires such a course of action. The Commission's reasons for permitting old gas to be repriced at the new rate apply equally to the related decision to abandon vintaging.

In the second national rate proceeding, Opinion Nos. 770 and 770-A, the Commission reversed its decision in Opinion No. 699-H, and reestablished vintaging. Opinion No. 770, 56 FPC at 521. The Commission held that while it was "aware of the problems occasioned by the continuance of the vintaging concept," it was necessary to reimpose vintaging in light of the magnitude of the increase in the previous national rate (from 50 cents to $1.42 per Mcf) and the need to "preclude the exaction of excessive and unjustifiable economic rent from flowing gas." 56 FPC at 521 (footnote omitted). Opinion Nos. 770 and 770-A were likewise affirmed on appeal, *American Public Gas Association v. FPC*, *supra*, in which the court held that "the Commission has latitude to reconsider its experiment in abandoning vintaging." 567 F.2d at 1033.

It seems clear based on the above-cited judicial precedents that the issues of replacement costs versus historical costs as well as vintage-based versus uniform rates are matters within the Commission's reasonably exercised discretion. Based on the record in this case, the Commission concludes that to continue the decision in Opinion Nos. 770 and 770-A to reinstate vintaging is no longer wise or consistent with sound regulatory policy. The record in this proceeding demonstrates that the pricing

of regulated gas below the marginal cost of gas produces distortions in the exploration and development of additional gas supplies and in the consumption of all gas supplies.[157]

The NGPA provides strong economic support for pricing old gas at the long-run marginal cost of gas, which is equivalent to replacement cost. As we have previously noted, Congress in enacting the NGPA implicitly recognized that the natural gas producing industry is workably competitive.[158] This fact has been recognized by the Commission[159] as well as the courts[160] and the validity of the competition premise has been amply demonstrated by experience subsequent to the NGPA's enactment.[161] We agree with the persuasive analysis of the Department of Justice concerning the determination of prices in a competitive market. DOJ summarizes that process as follows (DOJ at 7-8):

> In a competitive industry, market forces drive prices toward the producer's marginal cost. Where price equals marginal cost, consumers are paying precisely the social cost incurred to produce the last unit of output. If at any time the price is too high, excessive returns will encourage other producers to enter the market, thereby increasing production, lowering prices, and eliminating excessive returns. Similarly, if demand increases, price will rise, encouraging additional production that was not economically viable at the lower price. This process will continue until supply and demand reach equilib-

[157] *See* discussion in Sections IV. B and IV. D.

[158] *See* discussion, *infra* at 140-41.

[159] Order No. 436, 50 FR at 42418.

[160] *Pennzoil v. FERC*, 645 F.2d 360 (5th Cir. 1981); *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi*, 474 U.S. ——, 88 L.Ed. 2d 732 (Jan. 22, 1986).

[161] *See* discussion, *infra* at 140-44.

rium and price reflects marginal cost. Prices established by competitive market forces are in this way driven toward marginal cost. Such prices send the proper signals to both producers and consumers, leading them to produce and consume the optimal amount of goods and services, and thus ensuring that society makes the most efficient use of its resources. (Footnotes omitted).

Thus, in a competitive market, prices are driven toward marginal or replacement cost. In the terminology of economics this is referred to as unconstrained marginal cost pricing.[162] Since the natural gas market is in fact competitive. DOJ argues that market prices are just and reasonable *per se*, absent fraud, abuse or similar conduct. We agree that marginal costs best reflect the level at which prices would be established if deregulation of old gas were to occur. Since the purpose of regulation is to attempt to achieve the price, profit, output and efficiency levels that would exist were the regulated market actually competitive,[163] it follows that the regulated price should reflect marginal cost to the extent allowed by law. It should be noted that the post-1974 rate constitutes only a ceiling price. Under DOE's good faith negotiation rule, old gas would actually be priced at the prevailing market price or the new ceiling price, so the practical effect of the proposed rule is to provide a price for old gas equal to the market price or replacement cost, *whichever is lower*. Thus, to the extent the new ceiling price is not constraining, DOJ's analysis and conclusions apply. However, the new ceiling price serves as

[162] In *Tenneco v. FERC, supra,* the court recognized that "in a free market, competitive bidding would tend to equalize the prices of flowing and new gas. The Commission's vintaging policy insulates consumers from market forces and provides them with gas at one-fifth the price of replacement gas." 571 F.2d at 841.

[163] *Northern Natural Gas Co. v. FPC,* 399 F.2d 953 (D.C. Cir. 1968).

a regulatory guarantee that old gas prices will not exceed replacement cost even if marginal cost pricing would require such a result.

The fact that there is an excess of gas deliverability at the present time in no way affects the determination of the just and reasonable rate. As prices fall due to the current surplus, exploration and supply will decline[164] and demand and consumption will increase. At such time as supply and demand reach equilibrium, as they surely will, the price of deregulated gas will rise disproportionately above the market determined price unless the old gas price structure is modified, and the cycle of boom and bust will be repeated. Allowing old gas to be priced up to the level of replacement cost will help break the cycle. Obviously there can be no guarantee that the post-1974 price will remain market responsive due, among other things, to possible changes in the supply of and demand for gas, which ultimately determines the market price of gas. Thus there can be no assurance that there will not occur in the future a divergence in price as between new and old gas. However, we believe that the action taken in this rule represents a pragmatic approach the Commission can take within its authority under the NGA and NGPA to eliminate distortions in the price structure of natural gas and to make that structure more economically efficient. The effect of this rule will be to reduce significantly price distortions which would occur in the event no changes were made in the existing price structure.

Once the Commission has determined to base the new ceiling price for old gas on replacement cost, it must define the current replacement cost of gas. Then the Commission must determine how to incorporate replacement cost into the new ceiling price. The Commission must also decide whether to further adjust the new ceiling

[164] *See* IPAA at 3-4.

price by including additional factors in its definition besides replacement cost. Finally, the Commission must determine whether the new ceiling price, based on replacement cost and other relevant factors, is just and reasonable within the meaning of the Natural Gas Act.

In defining the current replacement cost of gas, the Commission has considered the comments in the record, its own precedents, and data on the technology of exploring for and developing natural gas reserves.

First, the Commission has considered its most recent definition of replacement cost, incorporated into the rate for new gas for the 1975-1976 biennium under Opinion No. 770-A and adjusted for inflation by Congress under the NGPA. Because this definition of replacement cost was affirmed on judicial review and incorporated by Congress into the NGPA, the Commission considers it an approved point of departure for determining the replacement cost of gas in 1986.

In Opinion Nos. 770 and 770-A, the Commission established a "zone of reasonableness" for the replacement cost of gas in the 1976 test year of between $1.31 per Mcf and $1.54 per Mcf, each escalating at 4 cents annually.[165] Based on this estimate of replacement cost, the Commission then set $1.42 per Mcf, also escalated 4 cents annually, as the new rate for post-1974 gas. NGPA section 101 then provided for escalation of the post-74 rate according to an implicit GNP deflator. Thus, the Opinion 770-A "zone of reasonableness" for the current replacement cost of gas, adjusted by the NGPA price deflator, would be between $2.37 per MMBtu and $2.79 per MMBtu in June 1986.

To determine whether the Opinion 770-A replacement cost is still reasonable, the Commission has reviewed the "discounted cash flow" ("DCF") methodology on which

[165] 56 FPC 567.

it was based. The DCF methodology, first used by the Commission in Opinion 699-H, recognizes that the value of an investment extends over time and that the present value of the cash flow from that investment must yield a rate of return comparable to other investments with similar risk. By examining the cash flow of the investment over the life of the project, the DCF analysis is able to account for cost of capital for invested funds, including dry hole expenditures, and variations in cash flow. By viewing the project in its entirety, the DCF analysis permits determination of a rate of return that compensates investors for their risks and encourages future drilling efforts.

Specifically, the DCF methodology used in Opinions No. 699-H and 770-A assumes a single project and focuses an anticipated cash flow over the life of a well rather than on revenues and costs in any one year as does a rate base cost of service method. The principal costs or negative cash flows are assumed to occur in the 3-year preproduction period. Operating expenses and other expenditures, as well as projected revenues, are assumed to occur during a 15-year productive period.

In addition to DCF analysis, Opinion Nos. 699-H and 770-A also applied modifications to the replacement cost methodology which originated in *Permian I*.[166] Basically, *Permian I* estimated the average unit cost per Mcf of gas produced from successful gas wells during a selected test period. The unit cost is derived by dividing the cost per foot of drilling and equipping the average successful gas well by its estimated productivity. Estimated productivity was derived by dividing the additions to nonassociated gas reserves by related gas well footage. However, the costs of unsuccessful wells were treated as expenses, and were not included in the investment rate base. *Permian I* then provided an average investment recovered over the depletion life of the average gas well.

[166] 34 FPC 159, *aff'd* 390 U.S. 747 (1968).

Besides modifying *Permian I* to adopt DCF analysis, Opinion 699-H included dry-hole expenditures in the rate base and considered the effects of Federal income taxes in its cost analysis. This is because exploratory drilling is the principal source of new gas supplies, and a successful exploratory drilling routinely will result in the drilling of many dry-holes. Thus, a key variable in the Opinion Nos. 699-H and 770-A cost methodology becomes "productivity," in terms of the amount of natural gas added to reserves for every foot of drilling that results in some addition to reserves. The productivity factor determines successful well cost per Mcf, which in turn underlies other cost inputs, such as dry-hole cost per Mcf, lease acquisition cost per Mcf, and other production and exploratory costs per Mcf.

In establishing the $1.42 per Mcf post-74 new gas rate, Opinion 770-A itself modified the Opinion No. 699-H cost inputs in certain respects. Drilling costs were changed to reflect higher costs actually incurred in 1973 and 1974. Productivity data were expanded from 7 years (1966-1972) to also include 1973 and 1974 data. The depletion life of the average well was changed from 18 years to 15 years (with a 3-year pre-production period). In view of the repeal of the percentage depletion allowance in the Tax Reduction Act of 1975, income tax liabilities were estimated based on a marginal tax rate of 48 percent. A 15 percent rate of return was allowed.

On judicial review, the D.C. Circuit affirmed the Opinion No. 770-A rate of $1.42 per Mcf against challenges to the DCF methodology and the inputs chosen by the Commission for drilling productivity and income taxes payable. In response to the charges that the Commission relied on unverified industry-collected data for successful feet of drilling and for gas reserves added, the court held that such reliance was not unreasonable, especially where the Commission attempted to correct for any weakness in the data by using an 8-9 year multi-year average.

Using the two multi-year averages (8 years and 9 years), the Commission had calculated average productivity as 300 Mcf/ft, the midpoint of a range between 279 Mcf/ft (9 years) and 323 Mcf/ft (8 years). In response to the contention that the Commission had estimated tax liability based on an economic model rather than on actual taxes paid, the court sustained the economic model. The model had assumed taxes payable at a 48 percent corporate rate, and estimated that 27 cents of the total 43 cents allowed for taxes was attributable to the repeal of the percentage depletion allowance effective July 1, 1976.

Based on this review, the Commission concludes that the Opinion No. 770-A DCF methodology, as sustained on judicial review, is still a reasonable methodology for calculating the replacement cost of gas. DCF analysis calculates replacement cost on the basis of the more reliable time value of money, and thus produces an estimate of the true yield over the life of an investment. In addition, the key input of productivity is calculated by using trended drilling costs and reserve additions over a multi-year range representative of the long-term nature of reserve replacement. The capitalization of dry-hole costs also recognizes the inherent long-term risks of exploratory drilling, itself the key variable in replacing gas reserves. Finally, Opinion No. 770-A includes an estimate for income taxes payable, in order to quantify the key role tax liability plays in drilling investments.

The Commission notes that Congress intended the replacement cost rate for post-'74 gas to be updated by reference to the implicit price deflator included in NGPA section 101. This is because section 101, when read in conjunction with sections 104(b)(2) and 106(c), preempts any attempts by the Commission to revise the NGPA ceiling price for post-74 gas *downward*, based on any Opinion No. 770-A DCF analysis that yields a current replacement cost of gas less than that yielded by the NGPA price deflator.

The second estimate of replacement cost the Commission has considered is the $2.77 per MMBtu estimate included in the initial comments of the Indicated Producers. The Indicated Producers updated the Opinion No. 770-A DCF analysis to include the most recently available data on productivity, reserve additions, income tax liability, drilling costs, and the industry capital structure.

A price adjustment of 4 percent annually over 15 years beginning in 1986 was used for the NGPA price deflator. Productivity was estimated at 145 Mcf/ft, based on a 5-year range of 120 to 159 Mcf/ft between 1980 and 1984. Income taxes were estimated on the basis of the current 46 percent corporate income tax rate and the 8 percent rate for investment tax credits.

Successful gas well and dry-hole costs per foot were calculated on the basis of an average of 1984 and 1985 costs calculated by the American Petroleum Institute and the Energy Information Administration. Lease acquisition costs were estimated as decreasing at the same rate as producing well costs, 15 percent annually since 1982, the most recent year for which actual least costs are available. Other exploratory costs were estimated on the basis of an assumption that they have decreased at the same rate as successful gas well costs since 1982, the last year actual data is available. In any case, the ratio of other exploratory costs to successful gas well costs is calculated to be the same as the 1979-1982 average, which itself is less than one-third the 1970-1974 average used in Opinion No. 770-A. Similarly, exploratory overhead costs are assumed to have decreased at the same rate as dry-hole costs since the last available data in 1982. Dry-hole footage and deeper dry-hole costs are based on 1981-1984 ranges.

Inputs not changed from the Opinion No. 770-A data include operating expenses, regulatory expenses, cost allocations to gas, royalty costs, other production facilities

costs, and recompletion and deeper drilling costs. Finally, based on the increased debt/equity ratios in the industry capital structure, a 13.25 percent computational rate of return was used, compared to 14.16 percent under Opinion No. 770-A.

The Commission considers productivity to be the factor most likely to affect the accuracy of the Indicated Producers' estimate. Productivity is the ratio of reserve additions to successful drilling footage, and the Indicated Producers use a 5-year range, as opposed to longer 8 and 9 years ranges used by the Commission in Opinion No. 770-A. In order to assure that the 1980-1984 productivity range of 120 to 159 Mcf/ft is not inconsistent with a more reliable range, the Commission has recalculated the productivity factor based on data for the most recent 8 years available, 1977-1984. This requires adding data for the years 1977-1979 to the 1980-1984 data used by the Indicated Producers. The following table summarizes the data:

Year	*Reserve Additions (Bcf)*	*Drilling Footage (000's)*	*Productivity (Mcf/foot)*
1977	13,098	59,538	220
1978	16,122	70.196	230
1979	13,326	77,756	171
1980	12,102	85,032	142
1981	15,351	96,846	159
1982	12,819	107,159	120
1983	10,131	83,202	122
1984	12,099	82,107	147
Used by Indicated Producers			145

This data indicates the 145 Mcf/ft estimate is within the range of productivity factors experienced since 1977. In addition, the other cost factors used by the Indicated Producers, such as dry-hole costs and successful well costs, are within the range of cost increases indicated by the general rate of inflation in the overall economy since Opinion No. 770-A. Finally, where certain cost factors, such as production facilities cost, other exploratory costs,

and lease acquisition costs, are extrapolated from less recent actual data by comparison to the general downward trend of drilling costs, the calculation appears reasonable.

For these reasons, the Commission concludes the Indicated Producers' $2.77/MMBtu replacement cost estimate is reasonable because it updates the Opinion 770-A DCF inputs to reflect changed industry conditions since 1976.

In reviewing these two estimates for replacement cost, the Commission has considered technological factors which affect the economics of reserve replacement.

As the office of Technology Assessment (OTA) has explained, the discovery of new gas fields represents the single most important force necessary for building a sustainable natural gas supply.[167] A new gas field not only adds to current reserves, it also provides a source of considerably larger additions to future reserves through field growth after the discovery year. Therefore, the economics of new field discovery rates are an important factor in defining the long-term replacement cost of gas.

According to OTA, the rate of annual additions to reserves from new field discoveries depends on several key variables:

—*The undiscovered resource base.* The geologic nature of the remaining resource base, such as amount; location, size, and distribution of fields; and types of geologic traps; all influence the future discovery of new fields. In this respect, the Commission notes that the *average size* of new gas fields has become considerably smaller over the last twenty years. Thus, the rate of new field discoveries is much more dependent today on sustaining a strong and stable

[167] *U.S. Natural Gas Availability: Gas Supply Through the Year 2000*, Office of Technology Assessment, OTA-E-245 (February 1985) at pp. 82-86.

level of drilling over time, than on the erratic discovery of a small number of giant fields.[168] For this reason, the Commission considers that the decline in gas well completions since 1981, accelerated by this year's collapse in drilling, will, if continued for several years, cause a serious shortfall in reserve additions beginning when the current surplus deliverability disappears. The Commission concludes that setting old gas prices at replacement cost would not only help stem any overall shortfall in gas drilling, it would also assure the availability of enhanced old gas supplies to plug the gap in reserve replacement when today's drilling slump causes a decline in new field discoveries by the early 1980s.[169]

—*Exploration, drilling, and production technology.* Overall discovery rates are affected by drilling success rates and development costs. These costs themselves are dependent on improvements in technology, hydraulic fracturing for tight sands, and offshore drilling techniques for deep water drilling. In this regard, the Commission notes that, although drilling costs may have declined since their late-1970s peak, the basic trend of new field discoveries—from high-permeability to low-permeability sands, from shallow to deeper zones, and from conventional techniques to more costly, complex, capital-intensive techniques—has not changed. For example, although most new field discoveries continue to come from more traditional gas producing areas, such as onshore and in the Gulf of Mexico, these areas are considered mature and future discoveries are expected to come by more expensive means, such as drilling in deeper waters of the Gulf or in tighter sands on-shore. For this reason, although the success rate of the domestic drilling industry can remain high, the Commission

[168] *Id.* at 85.

[169] *Id.* at 83.

concludes that the real costs of this success rate are likely to increase over the long-term, as the technology necessary to sustain the success rate keeps pace with the more complex and difficult geology of the new areas explored.

—*Historic and current gas prices, and industry willingness to take risks.* With new gas field discoveries coming from smaller fields and under more risky technologies and geology, gas prices and return on investment become much more important. Higher gas prices for current gas production increase cash-flow and internally generated capital in the drilling industry overall. But, as demonstrated by the commenters in this record, they also allow delayed abandonment or enhanced recovery of wells whose production would otherwise be uneconomic at current prices.[170] Higher prices are also a primary factor in encouraging exploration and development of those new field prospects that are already known through previous exploratory activities, but have not been developed because of economic conditions or the availability of more promising prospects elsewhere. According to OTA, the past exploratory experience of existing producers is therefore a principal determinant of positive charges in new field discovery rates over the short-term.[171]

Based on the technology and geology of new gas field discovery rates, the replacement cost of gas should be that price necessary to compensate for likely long-run increases in real drilling and development costs in frontier areas. The price should also assure that exploration and development capital is more efficiently allocated to enhancing recovery in existing fields or to drilling new prospects which are already known from past exploratory experience.

[170] *See e.g.* initial comments of Indicated Producers, DOE, AGA.

[171] *U.S. Natural Gas Availability*, op. cit. at 83.

The Commission considers that the current pre-1985 weighted average cost of new gas under sections 102 and 103 of the NGPA represents a reasonable non-cost factor on which to compare the two replacement cost prices established under DCF analysis. This is because the most recent period in which drilling levels sustained the highest level of reserve replacement was 1979-1984, the years when pipelines purchased the bulk of their new supplies of offshore and onshore gas. Because of the continuing distortions of the old gas cushion, these years also represent a balancing between the price distortions caused by perceived shortages at the beginning of the period and a perceived surplus at the end of the period. The years 1985 and early 1986 themselves represent one extreme of the these distortions. However, the *current* 1986 average cost of sections 102 and 103 gas ($3.14 per Mcf as of April 1, 1986) is used in order to assure an estimate at the conservative end of actual replacement cost.

Based on these two DCF estimates of replacement cost and the non-cost factor of current average new gas prices, the Commission concludes that the long-term replacement cost of gas is within a range whose low point is the estimate of replacement cost in Opinion Nos. 770 and 770-A, adjusted by the NGPA deflator ($2.57 per MMBtu as of June, 1986). The Commission concludes the high point of the range of current replacement cost is the Indicated Producers' updated DCF replacement cost estimate ($2.77 per MMBtu). The midpoint of this zone of reasonableness for replacement cost is $2.67 per MMBtu.[172] However, because of the volatility of the Indicated Producers' estimate of the productivity factor, the Commission will incorporate the low point of the replacement cost range, $2.57 per MMBtu, into the definition of the new ceiling

[172] The Commission notes that even the $2.77/MMBtu replacement cost estimate by the Indicated Producers is below the $3.14 per Mcf current average cost of new gas under NGPA sections 102 and 103.

price; $2.57 per MMBtu is the most recent estimate of replacement cost based on a full national rate case and is expressly updated by Congress to reflect the general effects of inflation. Although $2.57 per MMBtu may not as accurately reflect the changes in DCF inputs since 1976 as the Indicated Producers' $2.77 estimate does, the Commission nevertheless considers the lower estimate more reasonable, because it recognizes that any prediction of replacement cost is subject to constant changes in its input variables, such as productivity, income taxes payable, and drilling costs. Therefore, defining the new ceiling price for old gas based on the $2.57 per MMBtu low estimate will protect consumers against potential inaccuracies in the Indicated Producers' updated estimate. At the same time, $2.57 per MMBtu is within the minimum estimate of replacement cost necessary to compensate producers for the time value of money invested in finding and developing new supplies of gas for future consumers. For these reasons, the Commission determines that $2.57 per MMBtu is a just and reasonable ceiling price within the meaning of the Natural Gas Act.

However, the Commission also recognizes that current average wellhead prices, especially those in spot markets, are likely to be *below* the $2.57 per MMBtu new ceiling price when it takes effect. Because reserve replacement is tied closely to drilling, and drilling levels have declined substantially over the last 2 years, the Commission considers that current wellhead prices are themselves below the long-term cost of replacing gas reserves at the margin, even though they may accurately reflect the short-term marginal costs of buying gas in the market place.

In order to assure that old gas prices are paid at the current market price or the ceiling price, *whichever is lower*, the Commission has incorporated the "good faith negotiation" procedures into the ceiling price as a further restriction on its collection under existing contracts.

The "good faith negotiation" procedure prohibits a first seller from collecting the new ceiling price from an existing purchaser under an indefinite price escalator clause, unless the parties have mutually agreed to the new price under current market conditions. The "good faith negotiation" procedure thus is an integral part of the definition of the new ceiling price itself.

The $2.57 per MMBtu price established by this rule will operate only as a ceiling price, and actual prices paid for old gas in the market place are likely to be substantially *below* the ceiling price as long as the current surplus deliverability keeps short-term marginal costs below the actual replacement cost of gas. Of course, as the market clears the surplus and supply and demand come into balance, the market prices for old gas will more closely reflect its long-term replacement cost. When this happens, the $2.57 MMBtu price will restrict market forces from raising old gas prices above the just and reasonable ceiling price set by this final rule.

Based on the foregoing considerations as well as our findings concerning the unjustness and unreasonableness of the existing old gas price structure and the effect of the proposed rule on gas supply and overall prices, the Commission finds that the proposed ceiling price is just and reasonable within the meaning of the NGA.

D. Effect of Higher Prices on Old Gas Production.

The Commission finds that eliminating vintaging will substantially increase recoverable reserves of old gas through delayed abandonment of wells. Since a well's pressure and production decline over time, revenues from the well also decline. When those revenues no longer offset the costs of production (which remain relatively constant), a producer will abandon the well. Therefore, raising the ceiling prices for pre-1974 gas will permit production to continue to a lower pressure and level of

production, since revenues will not outstrip costs until production has fallen to a lower level.

Comments. DOE, large and small producers, public service commissions in producing states, and trade associations representing industrial and other large end-users generally agree that the proposed rule will result in increased production of old gas, since wells will remain economic to lower pressure levels. DOE estimates that the increase will be between 9 and 12 Tcf. Its best estimate is 11 Tcf.

DOE's estimate is based on a methodology first developed in a study by C. S. Matthews of the Shell Oil Company in April 1983 (the 1983 Shell study). That study sought to estimate the increased production resulting from total decontrol of natural gas prices. Dr. Matthews picked the fourteen largest gas fields in the U.S., accounting for approximately thirty percent of total nationwide production of old gas, as representative of all gas in the nation. For each field, the increase in recoverable reserves from lower abandonment pressure was estimated. The fourteen field data were then extrapolated to a nationwide basis [173] to estimate the total increase in production.[174] While DOE uses the same general methodology as Shell, it makes certain modifications both in the methodology and data employed. It makes these modifications in response to various criticisms of the Shell study made by Congress' Office of Technology Assessment

[173] The extrapolation was made as follows: First, total January 1, 1981 national reserves of old gas responsive to deregulation were calculated to be 115 Tcf. This figure was divided by the January 1, 1981 recoverable reserves in the fourteen fields of 41.3 Tcf to obtain a scaling factor of 2.8.

[174] The Shell study estimated that decontrol would permit production of an additional 27 Tcf through delayed abandonment. It also found that decontrol would bring about production of an additional 18 Tcf through infill drilling and 7 Tcf through additional production enhancement work, for a total of 52 Tcf.

(OTA)[175] and to reflect increased production from DOE's old gas proposal as opposed to total decontrol. For example, DOE assumes a price increase only to the new ceiling price. Also, it scales down the final result in order to correct for the fact that some of the increased production predicted by the Shell methodology would occur in any event under existing NGPA incentive prices.

Indicated Producers present an update of the Shell study to show the effect of the DOE proposal. The updated study assumes an increase in price to the new ceiling price but otherwise uses essentially the same data and methodology as the original study.[176] This study predicts that the old gas proposal will increase old gas production by 16 Tcf through delayed abandonment over the life of the old gas fields. Individual producers present data showing that their wells would remain economic for a longer period if vintaging is eliminated.[177]

Pipelines, distributors, their trade associations and consumer representatives generally either deny that elimination of vintaging will increase recoverable reserves or state that DOE and producers have greatly overestimated the increase. These commenters state that the DOE and

[175] These criticisms were made in a memorandum by the OTA staff entitled *Effects of Decontrol on Old Gas Recovery* dated February 1984. Congress's Technology Assessment Board neither reviewed nor approved the memorandum. The memorandum, while criticizing the Shell study, found that decontrol would permit production of an additional 7-20 Tcf through delayed abandonment, 7-14 Tcf through infill drilling, and 4 Tcf through well stimulation, for a total of 19-38 Tcf. OTA assumed that under decontrol prices would rise to \$3.50 to \$4.00 per MMBtu.

[176] The only change from the previous methodology was to use a somewhat smaller ratio in scaling the fourteen field result to the national level. This was done in order to account for the fact that certain intrastate gas which would have been allowed a higher price under total decontrol will not be allowed a higher price under the DOE proposal.

[177] *See* Hewit and Dougherty 17-20 and DuPont at 23-25.

Shell studies are flawed. For example, they claim that the fourteen fields chosen by Shell are not representative of the nation's gas fields generally, that much of the data used to estimate the increased production in the fourteen fields is unreliable or outdated, and that the studies improperly include in the predicted increase in production some gas which would be produced in any event under existing NGPA incentive prices such as those for stripper wells and production enhancement activities. AGA presents the most detailed critique of the DOE and Shell studies. A number of other commenters, including the Associated Gas Distributors, Northern Distributor Group, and the Northern Indiana Public Service Company, adopt AGA's comments.

Commission Response. The Commission believes that raising the MLP for all old gas to that permitted for post-1974 gas will substantially increase recoverable reserves of old gas since the additional revenue on pre-1975 wells to produce to lower pressure levels. The evidence presented by individual producers that elimination of vintaging would permit their wells to operate longer before costs out-strip revenues confirms this conclusion. For example, Hewit and Dougherty state that under the present 61¢ small producer ceiling price for flowing gas, their wells in the Normanna Field in Texas can produce only fifty percent of remaining reserves before costs outstrip revenues. An increase in price to $2.00, however, would permit their wells to produce 85 percent of those reserves, and an increase to the new ceiling price of $2.54 would permit production of 88 percent of reserves. They also observe that since the wells will in any event "water out" before production declines to the level necessary to qualify as a stripper well, none of this increased production could occur under NGPA section 108 incentive prices.[178]

[178] *See also* DuPont at 23-25.

Even the AGA, which has provided the most detailed critique of the Shell and DOE old gas supply response studies, concedes that there will be some increase; however it claims that the increase will be only about a third of that claimed by DOE.[179] While eliminating vintaging will increase recoverable reserves, the Commission recognizes the difficulty in predicting the precise amount of the increase in recoverable reserves. However, for the reasons stated below, the Commission believes that the increase will be substantial and that the DOE prediction of an approximate 11 Tcf increase is the most convincing analysis in the record of what that increase will be.

Some commenters argue that the fourteen fields relied upon in the DOE and Shell studies are unrepresentative of gas fields generally since they are larger than average. This allegedly results in overestimation of any increase in production since larger fields generally have larger increases in reserves over time. The commenters refer to the OTA's study in support of this contention. However, while OTA stated that most of the experts it consulted believed that the fourteen fields might have a larger supply response than the remaining fields, the reverse may be just as likely. OTA explained that economies of scale may have already permitted greater recovery of large fields' reserves than small fields' at current regulated prices.[180] Accordingly, small fields might have a greater remaining potential supply response than large fields, and use of the fourteen fields may lead to an underestimate of the overall supply response. In any event, while the size of the fourteen fields may mean that the predicted increase in reserves for those fields is not totally representative of that for the nation as a whole, no commenter presents any evidence to suggest that this problem so significantly distorts the results of the DOE

[179] *See* AGA reply comments at Appendix A, page 1.

[180] *See* OTA study at 43-45.

study as to undermine the conclusion that elimination of vintaging will bring about a substantial increase in recoveragle reserves.[181] In addition, the Commission observes that while the fourteen fields are larger than average, they do represent a wide range of characteristics, including discovery years from 1918 to 1963, depths ranging from 1450 to 20,000 feet, and both carbonate and sandstone reservoirs.

The opposing commenters' criticisms of the reliability of the data used in calculating the increased production from the fourteen fields do not undermine the conclusion that elimination of vintaging will cause a substantial increase in recoverable reserves in those fields. These commenters' specific criticisms are as follows. First, they state that the data for the pressure at which wells in the fields would be abandoned under existing prices is based on subjective engineering judgments which do not take into account the facts that pipelines might absorb certain costs such as the cost of compression and that producers might continue operating wells even after revenues go below production costs to avoid the costs of plugging the well. An overestimate of current abandonment pressures would lead to an overestimate of the supply response. They allege that some of the fourteen fields would not produce below their current abandonment pressure because water would intrude into the field below

[181] A recent EIA analysis of DOE's proposed rule supports the conclusion that the size of the fourteen fields does not cause DOE's study to underestimate the overall supply response. EIA did an independent study to determine the supply response from DOE's proposal. EIA based its study on production data from 557 fields in Texas rather than the 14 fields relied on by DOE. The 557 fields included many small fields as well as large fields. EIA nevertheless estimated the DOE proposal would result in increased production through delayed abandonment of 11.7 Tcf compared to DOE's 11 Tcf estimate. An Analysis of the Department of Energy's Notice of Proposed Rulemaking (NOPR), "Ceiling Prices: Old Gas Pricing Structure," EIA (May 1986) at 19-25. *See* further discussion of EIA analysis, *infra* at p. 164.

that pressure. They also complain that the data for current reserves and current pressure are for January 1981, are thus outdated and that a more accurate result would be obtained by using current data. They also complain that the figures for current field pressure are not the actual current field pressures, but represent estimates based on data for initial field pressure,[182] ultimate reserves, production to date, remaining reserves, and existing abandonment pressure.[183] Finally, the commenters contend that the Shell and DOE studies unrealistically assume that if vintaging is eliminated, prices of old gas will rise to the new ceiling price ($2.57 as of June 1986) even though current market prices allegedly are only $1.90 to $2.00 Mcf.[184] The lower the prices resulting from eliminating vintaging, the less the additional production that can be expected. AGA has presented a table substituting data for the fourteen fields which it alleges is more reliable than that used by Shell and DOE, including a price rise to $1.90 instead of $2.54.[185] AGA's table shows increased production in the fourteen fields of about 2.3 Tcf as a result of eliminating vintaging rather than the 7.2 Tcf found by Shell and the 5.7 Tcf found by DOE.

However, even accepting these criticisms and using the data suggested by the AGA as more accurate than that used by DOE for expected market prices, current reserves, field pressure, and abandonment pressure,[186] there

[182] These figures are also criticized as being estimated based on field depth, rather than being the actual field pressures.

[183] *See* MPC/NASUCA at 12.

[184] *See* APA, Appendix A at 1.

[185] *See* AGA, Appendix A.

[186] AGA's suggested data for current abandonment pressure presumably take into account its contention that pipelines will absorb certain costs including compression, and that the producer may continue operating the well even after costs outstrip revenues in order to avoid the costs of plugging the wells.

would be an increase in reserves for the fourteen fields of about 2.3 Tcf compard to the 5.7 Tcf predicted by DOE.[187] This is still a significant increase. In any event, the Commission believes that a number of the commenters' criticisms of the data used by DOE are unjustified and that AGA's data contains errors causing it to understate significantly the likely supply response. First, AGA assumes that prices will rise to only $1.90 per Mcf after elimination of vintaging. While $1.90 may be an accurate estimate of the prices producers could obtain at the present time, the problem here is to estimate the increase in recoverable reserves which would occur over the next ten or more years. For this purpose, estimated average prices over the next ten or more years should be used, not currently depressed spot market prices which are unlikely to continue over the long term.[188] The Commission believes that DOE's use of $2.52 per Mcf in 1985 dollars is more realistic than AGA's use of $1.90. While DOE's assumed price is not projected to occur until 1990, abandonment decisions are not based solely on current prices. Rather, a producer abandons a well when total predicted future costs are greater than total predicted future revenues. Thus, a producer might delay abandonment if it expects higher prices in the future. The majority of abandonment decisions will be made after 1990 in any event since old gas is not expected to be exhausted for approximately forty years.

Another error made by AGA is the fact that its figures are current reserves and field pressure mix 1981 and 1985 data. All but one of the reserve figures are for 1985, but only about half of the pressure figures are. This leads AGA to a further understatement of the predicted increase in recoverable reserves. This is because the Shell methodology calculates the predicted increase in

[187] *See* Table 2 of Appendix A to AGA's initial comments.

[188] OTA in its study emphasized the importance of using long-term, rather than short-term, prices. OTA study at 34-35.

recoverable reserves as a fraction of the total reserves remaining in the field at any particular time.[189] Generally, it makes no difference in the predicted increase in reserves at what time in the life of the field the figures for current reserves and pressure are taken, so long as consistent data are used. Both a field's reserves and pressure decline over time. While a lesser amount of remaining reserves would mean a lower predicted increase in reserves all other variables remaining the same, lower current pressure leads to a higher predicted fractional increase.[190] Thus, any decline in reserves resulting from using data for a later period in the life of the field is counterbalanced by the greater fractional increase in reserves resulting from lower current pressure. It follows that the commenters' criticism of Shell and DOE for using 1981, rather than current, data is unjustified. However, AGA's use of figures from different time periods distorts its results. For about half the fields, AGA fails to counterbalance use of the lower 1985 reserves figures with lower 1985 abandonment pressures. Instead, it uses the

[189] Specifically, Shell and DOE calculate the increase in recoverable reserves is calculated as follows:

where:

A = remaining reserves in field

B = abandonment pressure at current prices

C = abandonment pressure at new prices

D = current field pressure

E = increase in recoverable reserves

$$A \times \frac{B - C}{D - B} = E$$

[190] Pursuant to the formula set forth in the preceding footnote, the fractional increase is

$$\frac{B - C}{D - B}$$

Since current field pressure is D, lower pressure, means a lower denominator in the fraction, thereby increasing the fraction.

higher 1981 abandonment pressure figures, thus leading to a lower predicted fractional increase than if it had used 1985 abandonment pressures.

The Commission concludes that the commenters' criticisms of the data used by DOE in determining the increases in recoverable reserves in the fourteen fields do not undermine the essential conclusion that an increase in price to the post-1974 ceiling would cause a substantial increase in recoverable reserves in those fields. The Commission notes that some of the data, in particular the estimate of the pressures at which fields will be abandoned, is by its nature uncertain. Subjective engineering judgments are required, as OTA observed. Thus, no prediction of the increase in recoverable reserves in the fourteen fields can be exact. At best, one can predict a range within which the increase is likely to fall. The Commission believes that AGA's prediction, if adjusted for the errors discussed, would represent a prediction at the low end of the range. Even so, there would be a significant increase in recoverable reserves in the fourteen fields.

Once increased production from the fourteen fields as a result of an increase in price has been estimated, there remains the problem of extrapolating the nationwide increase. Furthermore, the predicted increase for the fourteen fields does not take into account the fact that some old gas may qualify for NGPA incentive or deregulated prices and thus be produced regardless of the elimination of vintaging or that other old gas, such as that subject to fixed price clauses, may not receive an increased rate, and thus may not be produced in any event. Opposing commenters contend that the Shell and DOE studies do not deal with these problems adequately. While the Shell study appears not to, the Commission believes that the DOE study did.

The 1983 Shell study dealt with both these problems simultaneously when it multiplied the predicted fourteen

field increases by the ratio of January 1981 national reserves responsive to decontrol [191] to January 1981 reserves in the fourteen fields.[192] DOE, however, in light of OTA's criticism of Shell's methodology, addressed separately the problems of scaling the fourteen field results to the national level and adjusting for the fact that the fourteen field results include non-responsive gas. With regard to the first problem, OTA noted that Shell's use of the ratio of remaining national reserves to remaining reserves in the fourteen fields could cause distortions if a different percentage of the gas in the fourteen fields had been produced than that of the nation as a whole.[193] For example, if the fourteen fields were less depleted than the national average, the scaling factor would be too large.

In order to avoid these possible distortions, OTA suggested use of the ratio of ultimate national reserves [194] to ultimate reserves in the fourteen fields. As OTA said, the reserve response from increased prices is a function of the true physical size of the field, not the amount of gas that happens to remain at any one time. DOE followed OTA's suggestion and scaled the fourteen field results to the national level by a ratio based on ultimate reserves. In fact, the fourteen fields do appear to be less depleted than the average fields so that use of a scaling factor based on remaining reserves tends to underestimate

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[191] It calculated those reserves to be 115 Tcf as follows. From January 1, 1981 national wet gas reserves of 206 Tcf, it subtracted 33 Tcf for North Slope gas, 20 Tcf for gas dissolved in oil, and 20 Tcf for water drive reservoirs. Based on AGA data for newly discovered reserves, it estimated that about 85% of the remainder, or 115 Tcf, was old gas that would respond to deregulation.

[192] The ratio used for purposes of extrapolating from the fourteen field results an estimate of nationwide increased recoverable reserves is is referred to as the "scaling factor."

[193] *See* OTA study at 45-46.

[194] Ultimate reserves equal proved reserves plus cumulative production.

the national increase in recoverable reserves due to elimination of vintaging. The scaling factor obtained by DOE is 3.5 [105] as opposed to Shell's scaling factor of 2.8. AGA failed to correct for this distortion, but continued to use a scaling factor based on remaining reserves. Thus, for this reason alone, its methodology underestimates the increase in recoverable reserves resulting from adoption of this rule.

Having extrapolated the fourteen field results to a national level, DOE, like OTA, then addresses the problem of adjusting the predicted increase in reserves to include only that increase which would occur as a result of elimination of vintaging. First, DOE recognizes that some increased production would occur in any event under the existing section 108 incentive prices for stripper wells.[106] DOE estimates that such production accounts for about four percent of the estimated increase and subtracts that amount from its estimate of the total increased production resulting from elimination of vintaging.[107] Thus, it

[105] In light of OTA's statements that Shell's data for the ultimate reserves of both the nation and the fourteen fields might be unreliable, DOE used for ultimate reserves the lower-48 states estimate for Dec. 31, 1977, reported in Reserves of Crude Oil, Natural Gas Liquids, and Natural Gas in the United States and Canada—1979, American Petroleum Institute/America Gas Association, Volume 34, June 1980. DOE based its figure for ultimate reserves in the fourteen fields on a 1980 study prepared for the AGA and presented by it to OTA. *See* OTA study at 73.

[106] OTA criticized Shell for failing to take this into account. OTA study at 49-51.

[107] In its May 1986 study analying DOE's proposed rule (*see* note 181, *supra*), EIA stated that production from stripper wells accounts for only about 2.3 percent of annual U.S. production. EIA concluded that the NGPA incentive price for stripper gas has not resulted in significant additional supplies of gas, and therefore EIA made no adjustment in its prediction of increased supplies due to delayed abandonment to account for gas which would be produced in any event under stripper prices. Thus, the EIA study supports DOE's estimate that no more then 4 percent of increased production as a result of higher prices would occur pursuant to NGPA stripper prices.

is not true, as some commenters contend, that DOE has not accounted for the production which would occur in any event pursuant to section 108 stripper prices. Second, in order to account for other gas that would also receive adequate prices to stimulate full economic production under current regulations, DOE made a further, more significant adjustment to the predicted increase. While the 1983 Shell study had calculated a January 1, 1981 responsive reserve base of 115 Tcf, DOE estimated that, in fact, only about 66 Tcf of old gas would not receive adequate prices under current regulations but would respond to higher prices, as of January 1, 1981. Accordingly, DOE scaled down its estimate of increased production by 66/115, or about 57 percent, to achieve its final estimate of 11 Tcf.

DOE's estimate of responsive reserves is at the low end of OTA's estimated range of 65 to 75 Tcf and is based on a methodology suggested by OTA. Relying on data in a study prepared for AGA,[108] DOE determined the percentages of each category of old gas likely to respond to higher prices allowed by eliminating vintaging. It then multiplied the amounts of old gas in each category as of December 31, 1980, by these percentages and totalled the results.

AGA contends that the responsive reserve base is only 45.5 Tcf, as opposed to DOE's estimate of 66 Tcf.[109]

[108] *Trend in Natural Gas Purchases by NGPA Category*, Foster Associates (for the AGA), May 1983.

[109] AGA apparently assumes that only proven reserves committed to interstate commerce at the time the NGPA was enacted would respond to elimination of vintaging. It therefore takes 1978 national proven reserves and subtracts North Slope gas, gas associated with oil, water drive gas, and all intrastate gas to obtain 1978 year-end reserves affected by decontrol of about 95 Tcf. It then estimates the amount of such gas produced since 1978 as

However, the Commission considers DOE's estimate more accurate than AGA's for present purposes. AGA makes at least two errors in its analysis. First, it subtracts all intrastate gas. However, in light of the fact that contracts for the sale of some intrastate gas are keyed to Federal price ceilings and that the Comission is amending the DOE proposal to allow intrastate rollover gas to qualify for higher prices, inclusion of some intrastate gas appears appropriate. Second, and more important, AGA has subtracted from reserves all production through 1985. However, Shell's 115 Tcf represents an estimate of national reserves as of January 1, 1981. This allowed Shell to use consistent data in extrapolating its results from the fourteen fields to the national level, since its figures for reserves in the fourteen fields were also for January 1, 1981. Obviously, use of 1985 national reserve figures for this purpose would result in too low a scaling factor unless the reserves for the fourteen fields were also reduced to account for 1981-1985 production from those fields. For similar reasons, DOE correctly used December 31, 1980 reserves in adjusting for Shell's overestimate of responsive reserves. As explained above, DOE scaled down its prediction of increased production by the ratio of its estimate of responsive reserves to Shell's. Since Shell's was an estimate for January 1, 1981, consistency required DOE to use an estimate for the same period.

For all the reasons stated above, the Commission concludes that elimination of vintaging will substantially increase recoverable old gas reserves and that DOE's 11 Tcf estimate of that increase is a reasonably reliable estimate. The Commission recognizes, as emphasized by OTA, that no estimate of the increase in recoverable reserves can be exact. Much of the data used in making the estimate is itself estimated, including abandonment

about 50 Tcf. Subtracting this from the 95 Tcf gives 1986 reserves affected by decontrol of about 45 Tcf.

pressures in the fourteen fields and the amount of reserves responsive to elimination of vintaging. Also, the increase in production depends in part upon uncertain future market prices which will determine the producers' ability to charge up to the new ceiling price. Nevertheless, even if the increase in recoverable reserves cannot be quantified exactly, the Commission finds that there is a direct relationship between price levels and the length of time operation of a well remains economic. Pre-1975 gas will receive a substantial price increase as a result of the rule. That price increase will cause a substantial increase in recoverable reserves through delayed abandonment. The inability to quantify exactly that increase does not vitiate the Commission's finding that it will occur.[200] If producers do not collect at the full ceiling price, reserve additions may not be as substantial but any potential negative impact on consumer prices will likewise be less.

This substantial increase in the production of old gas will benefit the public interest. Apart from the fact that in a workably competitive market it will displace higher cost gas, thus causing overall consumer prices to decline (which will be discussed in more detail in the next section), it will have other benefits. It will aid national security since any increase in domestic gas production reduces the nation's dependence on foreign oil and gas. The less oil and gas we import, the less dependent our economy is on uncertain imports of oil and gas from unstable areas. Also, reducing imports of foreign oil will reduce trade imbalances.

Some commenters have argued that, even assuming DOE's estimate of increased production is correct, the incremental cost of that production would be exorbitant and therefore such production would not be beneficial. For example, United Distribution Companies has pre-

[200] *See Mobil Oil Corp. v. FPC*, 417 U.S. 283, 318-19 (1974).

sented a study purporting to show that the incremental cost of the additional old gas supplies would be from \$3.75 to \$5.77 per Mcf in 1985 dollars depending on whether prices for old gas rise to the new ceiling or to a lower market price.[201] These commenters obtain their high incremental cost estimates for additional old gas by determining purchasers' increased cost of purchasing all old gas as a result of this rule and dividing the result by DOE's estimated increase in recoverable reserves. This calculation fails to take into account the reduction in price of higher cost gas which will occur as a result of this rule. As discussed in detail in the next section, the Commission believes that increased production of old gas will reduce overall consumer costs by delaying the need for exploration and development of higher cost gas. This being the case, it is clear that the claims of a high incremental cost for the increased production are invalid.

Overall the only certainty about future natural gas supplies is their extreme uncertainty. The Commission notes that two recent authoritative studies predict that production of natural gas from conventional sources within the lower 48 states could range from 14 to 20 Tfc in 1990 and 9 to 19 Tcf by the year 2000, compared to current production of 17-18 Tcf annually.[202] These studies confirm that the key variables in such projections—price and demand—are highly uncertain and insusceptible of accurate prediction beyond the very short-term.

The Commission does draw several general quantitative and qualitative conclusions from current data on natural gas supplies:

1. Natural gas supplies are adequate for the short-term, but the Commission is obligated to establish rates

[201] See UDC reply comments, Appendix A.

[202] OTA Study, *supra* at p. 6; AGA Gas Supply Committee Report, *supra* at p. 7.

which call forth adequate supplies for the long-term as well. The current surplus is one of deliverability, not reserves. Although surplus deliverability is reported at an annual level of 3 Tcf, lower-48 proved domestic reserves have declined from 291 Tcf to 197 Tcf since 1970.[203]

2. Even after seven years under the NGPA, 90 percent of gas well completions have been in regions thought to contain only 30 percent of remaining reserves. On the other hand, 63% of our remaining reserves are in "hard to develop" areas—such as Alaska, offshore, or at depths below 15,000 feet.[204] This means that future gas exploration and production will inevitably be more expensive, in real terms, than current production.

3. The risks and costs of exploratory drilling and development of gas reserves in frontier areas, such as the OCS and deep formations, are greater than the likely costs of increased production through delayed abandonment of old gas.[205] Delayed abandonment of old gas is only possible under higher prices, and will enhance more efficient timing of, and investment in, natural gas exploration, development and production. This is because, although delayed abandonment cannot substitute for reserve replacement over the long-term, it can postpone more costly investments in exploration and development of frontier gas areas over the near term by increasing the supply of lower-cost gas.

[203] EIA, *Natural Gas Monthly*, *supra* at Table 6 (February 1986); EIA, *U.S. Crude Oil, Natural Gas, and Natural Gas Liquids Reserves, 1984 Annual Report* (September 1985), *supra*. In addition, if the recent collapse in oil and gas drilling and drastic reduction in exploration and development budgets persists, reserve replacement in 1986 and subsequent years can be expected to decline on a more accelerated basis, unless the existing price structure for old gas is revised.

[204] AGA Gas Supply Committee Report, *supra* at p. 6.

[205] OTA Study, *supra* at pp. 7-10.

4. Investment in exploration and development of gas reserves is most efficient if it is made on the basis of long-term risk and return, rather than on the basis of short-term prices in gas markets. This is because oil and gas exploration is risky, and development of reserves requires long-term security of financing. The experience of deep gas drillers under thet NGPA proves that short-term perceived shortages in gas markets are no substitute for long-term considerations, such as growth in the general economy and potential fuel substitution. For this reason, the best time to raise old, flowing gas prices is in the midst of a perceived short-term surplus, such as today, because future producer investment will be more efficiently allocated to those projects with the best long-term return to gas purchasers, rather than those more costly projects which would be required absent this rule.

For these reasons, the Commission concludes that the new just and reasonable rate in the final rule will enhance efficient investment in the replacement of domestic natural gas reserves over the long-term, in response to competitive wellhead markets.

E. Effect of Higher Old Gas Prices on Overall Gas Prices

Comment Summary. DOE, producers, their trade associations, public service commissions representing producer states, and some industrial and other larger end-users contend that the proposed rule will reduce overall natural gas prices. They assert that the increased production of old gas resulting from elimination of vintaging will displace more costly new and imported gas. This will place strong downward pressure on the price of that gas. Furthermore, the expectation of lower future prices will cause some producers to shift production of some less costly reserves to earlier periods when prices are relatively higher. This will add to the downward pressure on current prices. At the same time production of higher

cost reserves will be delayed, further reducing costs to consumers.

Elimination of the old gas cushion, which currently subsidizes above-market prices for some gas, will reinforce these downward pressures on the price of high-cost gas. Purchasers will no longer be willing or able to pay above-market prices for new and high-cost supplies. Producers will have to reduce the price of that gas or face a significant loss of sales. In short, both producers and purchasers will find it mutually advantageous to renegotiate high-cost contracts in order to market the gas. DOE's computerized mathematical model of the United States natural gas market predicts that the decrease in prices to consumers will range from 19¢ to 55¢ per Mcf during the period 1986 to 1995.

Pipelines, distributors, and consumer representatives all dispute the contention that overall prices will decline. They assert that the claim of a price decline is based solely on economic theory and is without factual support. They argue that the elimination of vintaging will cause a huge increase in prices to consumers. Elimination of vintaging allegedly will cause almost all pre-1975 gas, which currently sells for an average of approximately $1.26,[206] to rise at least to the current market price of about $2.00. However, the increased cost of pre-1975 gas will not be offset by reductions in the cost of other gas.[207] Post-1974 old gas will remain at its $2.57 ceiling price since there is no provision in the rule for renegotiating the price of that gas down to market levels. New gas, which is sold under market responsive contracts, has already been reduced to approximate market levels and cannot be expected to decline much further. New gas sold under non-market responsive pricing provisions including take-or-pay clauses also will not come down in price since

[206] DOE, Appendix C at 3.

[207] AGPA at 21-24.

producers have no incentive to renegotiate such contracts. Opposing commenters state that the fact pipeline WACOGs remain substantially above the spot market price of gas demonstrates pipelines' inability to renegotiate take-or-pay contracts. Since a surplus of natural gas lasting over two years has not forced renegotiation of inflexible contracts to market levels, the production of still more gas is not likely to have that effect.[208]

Both AGA and INGAA have presented studies asserting that in the absence of significant renegotiation of non-market responsive contracts, interstate pipeline WAGOGs will rise substantially.[209] Many individual pipelines and their customers have presented analyses calculating the increase in their pipeline's WACOG if DOE's proposed rule is adopted. A number state that even a reduction in price of the pipeline's high-cost gas to market levels would not offset the increased cost of old gas.[210]

Finally, opposing commenters state that DOE's proposed rule will have a particularly adverse impact on captive (primarily residential) consumers.[211] The increased prices pipelines will be forced to charge their customers will encourage those who can to buy cheaper gas on the spot market. These customers are primarily large industrial users, electric utilities and some distributors. The remaining customers will have to bear a larger share of the pipeline's fixed costs and take-or-pay liabilities.

Commission Response. The Commission believes that the more accurate price signals and increased supply of

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[208] *See*, for example, MPC/NASUCA at 17.

[209] AGA, Appendix B. INGAA at 32-38.

[210] *See*, for example, the comments of KN Energy, Inc.; Natural Gas Pipeline Co. of America; El Paso Natural Gas Co.; Peoples Gas Light and Coke Co.; Northern Illinois Gas Co; and Citizen/Labor Energy Coalition at 24-25.

[211] *See*, for example, UDC Appendix A at 37-38.

old gas encouraged by the elimination of vintaging will reduce natural gas prices below what they would be with continued vintage-based pricing. Because the additional old gas is produced by continuing the operation of existing wells, the costs of producing that gas will be less than the costs of producing new gas. New gas is generally produced either through drilling for and discovering new sources of gas or applying expensive development techniques to existing fields. In addition, the transmission cost of the old gas is generally less than that of the new, since the old gas is already connected to a pipeline. The Commission believes that in today's highly competitive market, an increased supply of low-cost gas, and more accurate prices signals for all gas, will reduce prices to pipelines and consumers.

Commenters who claim prices will rise rely on an assumption that the natural gas market is not fully competitive. That is the only basis for contentions that, in spite of the loss of the old-gas cushion, take-or-pay clauses will prevent high-cost gas from falling in price. The Commission believes, however, that the market for wellhead natural gas sales is workably competitive. In the first place, Congress so found when it enacted the NGPA. Implicit in the removal of the Commission's authority to regulate the price of new gas is a finding that the wellhead market for natural gas is competitive. As the court stated in *Pennzoil v. FERC*, 645 F.2d 360, 378-79 (5th Cir. 1981), "Contrary to the Supreme Court's assumption in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), which subjected gas producers to utility-type regulation under the NGA, Congress apparently decided that gas producers do not have 'natural' monopoly power." Similarly, in *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Mississippi*, 106 S. Ct. 709, 717 (1986), the Supreme Court stated, "the NGPA reflects a Congressional belief that a new system of natural gas pricing was needed to balance supply and demand. . . . The new federal role is to 'overse[e]' a

national *market price* regulatory scheme'" (emphasis added).

Congress' determination that wellhead markets are workably competitive has been borne out by experience under the NGPA and strengthened by past Commission decisions. In the past two years, as a surplus of natural gas has developed, market forces have significantly reduced overall prices paid by pipelines for gas. As shown below in Table 1, WACOGs of the major interstate pipelines have fallen from $2.84 in February 1984 to $2.51 in February 1986.

Table 1

Trend in Projected Decontrolled Gas Prices and Pipeline WACOGS: 30 Major Interstate Pipelines [a] ($/MMBtu)

Month Year (1)	*107 Deep Gas* (2)	*Other Decontrolled Gas* (3)	*Total Field Purchases* (4)	*Canadian Imports* (5)	*Total Purchases* [b] (6)
2/84	$5.82	—	$2.75	$4.58	$2.84
4/84	5.45	—	2.73	4.63	2.88
6/84	5.45	—	2.74	3.96	2.84
8/84	5.42	—	2.75	3.86	2.84
10/84	5.47	—	2.77	3.79	2.84
12/84	5.29	—	2.76	3.91	2.85
2/85	5.16	$3.67 [c]	2.76	3.70	2.84
4/85	4.85	3.63	2.72	3.53	2.80
6/85	4.60	3.52	2.66	3.40	2.72
8/85	4.43	3.38	2.60	3.20	2.66
10/85	4.40	3.28	2.57	3.20	2.64
12/85	4.31	3.19	2.47	3.04	2.55
2/86	4.21	3.09	2.44	3.02	2.51

[a] Gas prices and WACOGs beginning 2/84, 4/84, 11/84, 1/85 and 6/85 are for 24, 26, 28, 29 and 30 pipelines, respectively.

[b] WACOGs exclude inter-pipeline transactions.

[c] Effective 1/1/85 sections 102(c), 103 wells deeper than 5,000 ft., and 107(c)(5) were decontrolled.

Source: PGA filings of interstate pipelines effective as of the date shown as tabulated in Foster Associates' *Current Purchased Gas Costs of Interstate Pipeline Companies* (monthly).

The price of all gas decontrolled under the NGPA has fallen from $3.67 in February 1985 to $3.09 in February 1986. In addition, the price of gas still subject to price ceilings has fallen substantially below those ceilings. For example, in November 1984 the ceiling price for price-controlled section 102(d) gas was $3.82 and the actual price was $3.78. By February 1986, the ceiling price was $4.19 but the average price had fallen to $3.24.[212] As shown below in Table 2, since November 1985 pipelines have been regularly marketing out under contracts in all NGPA categories at prices significantly below the post-1974 gas ceiling price.

Table 2

Date (1)	*Pipeline* (2)	*NGPA Categories Affected* (3)	*New Price* (4)	*Notes* (5)
11/85	Mid-Louisiana	All	2.25	
11/85	Houston Natural Gas	All	2.20	Gas well gas.
11/85	Northwest Pipeline	All	2.58	85% of No. 6 Seattle/Portland.
11/85	Texas Gas Transmission	All	2.25	
11/85	Transcontinental Gas P.L.	All	2.15	
11/85	United Gas Pipe Line	All	2.00	Includes taxes.
1/86	ANR Pipeline	All	2.10	Includes taxes.
1/86	Colorado Interstate Gas	All	2.15	
1/86	Columbia Gas Transmission	All	2.70 2.50	Appalachian SW, Rockies, Mid-Cont.
1/86	Natural Gas Pipeline	All	1.90	Includes taxes.
1/86	Northern Natural Gas	All	2.35	Floor
2/86	Florida Gas Transmission	All	1.90	Not to exceed 65% of No. 6 oil.
2/86	Transwestern Pipeline	All	2.50	
4/86	Northwest Pipeline	All	2.08	
4/86	Southern Natural Gas	All	2.06	
4/86	El Paso Natural Gas	All	2.20	

Source: Indicated Producers Reply Comments, Appendix E at 9.

[212] Indicated Producer's reply comments, Appendix E at 8.

The competitive forces bringing down the price of gas include not only competition in producer markets among suppliers of natural gas, but also competition in consumer markets among suppliers of gas and alternative fuels including residual fuel oil. As the prices of crude oil and residual fuel oil have fallen, producers and pipelines have had to reduce their prices in order to remain competitive and avoid losing markets. Many natural gas customers can easily switch to alternate fuels if these fuels became cheaper than gas. For example, electric utilities can burn residual fuel oil in some boilers now burning gas. A number of large industrial and commercial customers can also switch fuels.[213]

It is true, as observed by opposing commenters, that pipeline WACOGs continue to average above the spot market price of gas ($2.42 per MMBtu as opposed to $1.90 to $2.00 per MMBtu).[214] However, this fact does not negate the conclusion that the natural gas market is workably competitive. First, in a competitive market, spot market prices should be different than overall prices. Spot market sales are short-term sales. Purchasers will generally have to pay higher prices for long-term sales since such sales give them greater security of supply. Furthermore, contracts entered into immediately after the NGPA was enacted were negotiated at a time of serious natural gas shortages caused at least in part by earlier rigid, cost-based regulation of wellhead prices under the NGA. Pipelines were just emerging from a period of curtailments and were anxious to replenish their reserves. The result was that new gas was purchased at the applicable NGPA maximum lawful prices and even higher prices were paid for price-deregulated supplies. These high prices increased supply and reduced

[213] Increasing Competition in the Natural Gas Market. The Second Report Required by section 123 of the Natural Gas Policy Act of 1978 (January 1985).

[214] *See*, for example, MPC-NASUCA at 16, 17.

demand, converting the shortage into a surplus. This has brought about today's lower market prices, demonstrating that the natural gas market is workably competitive. To the extent overall prices remain above spot market prices, it is largely because pipelines continue to have contracts entered into during the earlier period of shortage. Furthermore, the existence of the old-gas cushion has permitted the price of new gas sold under non-market responsive contracts to remain at higher levels. However, in a market characterized by surplus deliverability and intense interfuel competition, supplies of gas cannot sustain above-market prices even under existing contracts, and elimination of the old gas cushion will put added pressure on already-declining high-cost gas prices, which in time will reduce pipeline WACOGs.

Given the fact that the wellhead natural gas market is workably competitive, and that the Commission is allowing for the renegotiation of all gas in contracts containing any old gas under the good faith renegotiation rule, the Commission is unconvinced by the opposing commenters' contentions that prices will rise if vintaging is eliminated. These contentions are all based, in one form or another, on the assumption that prices for pre-1975 gas will rise substantially, and relatively high-cost gas will not decline sufficiently to offset this increase. However, this cannot happen in a competitive market. The opposing commenters contend, for example, that new high-cost gas sold under market responsive contracts[215] cannot be expected to decline in price very much since it has already been reduced approximately to market levels.[216] However, the current market price of such gas

[215] These contracts were entered into primarily after 1982 and, according to INGAA (at page 30), account for approximately 25% of all gas.

[216] INGAA (at 30) estimates that the price of such gas now averages about $2.35.

takes into account the old-gas cushion. Once the cushion is removed, and pipelines pay more for pre-1975 gas, competition will require pipelines to seek a lower price for high-cost new gas. Where contracts for sale of new gas have market-out clauses, pipelines clearly have the ability to force down the price of such gas and any assumption that the price of this high-cost gas cannot decline significantly is unrealistic.

Opposing commenters also contend that high-cost gas sold under so-called non-market responsive contracts[217] cannot come down in price. These commenters claim that producers will have no incentive to renegotiate high-cost contracts. They state that pipelines cannot link renegotiation of take-or-pay obligations to allowing increased prices for the old gas, since if they do producers can simply sell the old gas to someone else. Furthermore, they state that Order No. 436 prohibits pipelines offering non-discriminatory transportation from refusing to transport the gas to a third party unless the producer grants take-or-pay relief. The Commission believes, however, that the elimination of the old-gas cushion, together with the increased production of low-cost old gas, will accelerate renegotiation of the price of substantial volumes of that gas. Producers and pipelines will simply have to renegotiate lower prices for this gas in order to avoid a significant loss of market to lower-priced gas and alternate fuels.

Opposing commenters' contentions concerning the impossibility of renegotiating contracts for the sale of this gas are unconvincing. In April 1985, the Commission issued a policy statement, reaffirmed in Order No. 436, stating that pipelines may buy out their take-or-pay liability without violating NGPA ceiling prices and that the Commission will grant expedited treatment of abandonment requests necessary to implement take-or-pay buyouts.[218] Pipelines have been successfully renegotiating their take-or-pay contracts pursuant to the April 1985 policy statement. For example, in Order No. 436, the Commission noted that its records disclose eight settlements by major pipeline companies discharging $421,275,035 in take-or-pay liability for $80,761,007 or less than 20¢ on the dollar.[219] NGSA has presented a table showing nine settlements discharging take-or-pay liabilities of $3,626,275,035 for $435,461,007, or about 12¢ on the dollar.[220] An NGSA survey of producers shows that they have settled over two thirds of their outstanding take-or-pay liabilities and that most of the remaining liability is of recent origin.[221] Finally, a survey of interstate pipeline financial statements filed with the Securities and Exchange Commission shows pipelines repeatedly stating that they expect to renegotiate take-or-pay contracts.[222] Thus, pipelines have been able to renegotiate high-cost take-or-pay contracts for new gas.

The Commission believes that elimination of vintaging can only accelerate this process. Pipelines will be able for the first time to offer higher prices for old gas in return for voluntary renegotiation of take-or-pay contracts. In addition, since there will no longer be an old-gas cushion available to protect high-priced contracts through rolled-in pricing, both pipelines and producers will find it mutually advantageous to renegotiate such contracts in order to retain a market for their supplies in the face of competition from cheaper gas and alternate

[217] These contracts were primarily entered into from 1978 through 1981 and, according to INGAA, cover about 28% of all gas.

[218] *See* 18 CFR 2.76 and 2.77(a)(1) (1985).

[219] 50 FR 42408, 42464 (October 18, 1985).

[220] *See* NGSA reply comments, Appendix B, Attachment 3.

[221] *See* NGSA reply comments, Appendix B, Attachment 1. The survey shows that settled liabilities equal $5,698 billion, while unsettled liabilities equal $2,552 billion.

[222] Indicated Producers Reply comments, Appendix C.

fuels. Furthermore, in cases where pipelines threaten to stop purchases by invoking the *force majeure* provisions of their contracts, producers may prefer the certainty of receiving the market price to the delay and uncertainty of litigation in attempting to enforce high-price take-or-pay contracts.[223] The Commission therefore rejects the assertion that high-cost gas sold under take-or-pay contracts will not come down in price in response to the elimination of vintaging.

Moreover, while the Commission believes that high-cost non-market responsive gas under all contracts would come down in price gas even under the rule as proposed by DOE, the Commission is modifying the good faith negotiation rule in order to give the purchaser the right to renegotiate gas prices on a contract-by-contract basis under that rule. Specifically, the Commission is providing that where the producer requests the purchaser to nominate a new price for old gas in one contract, the purchaser may request the producer to nominate a new price for any new gas in that contract or in any other contract between the parties which also contains old gas. If the purchaser rejects the price nominated by the producer, it may discontinue purchases of that gas upon thirty days notice. This modification of the good faith negotiation rule provides the purchaser a powerful additional bargaining card to negotiate a lower price for new gas in multi-vintage contracts including those which are not market-responsive and buttresses the Commission's conclusion that the average price of high-cost gas will be significantly reduced under this rule. The Commission therefore rejects the assertion that high-cost gas sold under take-or-pay contracts will not come down in price in response to the elimination of vintaging.

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[223] *See, e.g.*, various "released" gas programs undertaken by many pipelines, in which they take substantial volumes of new and high-cost gas in exchange for price relief.

Opposing commenters also assert that post-1974 gas will remain at its $2.57 ceiling price since there is no provision in the rule as proposed for renegotiating contracts covering that gas. The Commission believes, for the reasons already amply stated above, that even in the absence of market-out clauses in the contracts for the sale of this gas, competitive forces released by the elimination of vintaging will work to lower the price of post-1974 gas so long as overall market prices remain below the ceiling price for this gas. However, in order to provide that renegotiation of old gas prices under the good faith negotiation rule is undertaken on a generic basis, the Commission's modification of DOE's good faith negotiation rule will provide additional assurance that this occurs. Under the rule as modified, where a producer requests its purchaser to nominate higher prices for any old gas, the purchaser may request the producer to nominate lower prices for old gas which the purchaser believes is being sold at above-market prices. The modification of the good faith negotiation rule thus assures that all old gas will be market-responsive and will assure that all old gas will be priced at a market-clearing level. There is no merit to commenters' arguments that the ceiling price for post-1974 gas, which this rule makes applicable to all old gas, will act as a floor for the price of old gas. The evidence cited previously that pipelines are currently marketing out on gas at prices well below the post-1974 ceiling price demonstrates that in today's competitive natural gas market that ceiling does not act as a price floor.

Elimination of vintaging will reduce overall prices below what they otherwise would have been by increasing production of cheaper gas and eliminating the old-gas cushion. This conclusion is supported by the movement of gas prices following partial decontrol of natural gas on January 1, 1985. Before decontrol, there were predictions of a price fly-up unless actions were taken to deal with take-or-pay contracts and to cap indefinite price

escalators.[224] Yet no such fly-up occurred. In the first year after partial decontrol, natural gas prices at the wellhead declined by 33¢ per Mcf. This demonstrates that the natural gas market is sufficiently competitive that removing price ceilings does not cause an increase in prices. The forces of the market-place require producers and purchasers to keep their prices at market clearing levels so as to avoid loss of sales. The fact that oil prices have declined since oil prices were decontrolled in January 1981 is further evidence that removal of price ceilings in a competitive market does not cause price increases.

Finally, the Commission observes that eliminating vintaging will not only reduce prices below what they otherwise would have been, it will make prices more stable. When the current surplus is dissipated,[225] natural gas prices will rise in order to encourage producers to produce the additional gas necessary to satisfy demand. So long as current old-gas price ceilings remain in effect, the entire additional supply increase must come from new gas. Thus, new-gas prices would have to increase substantially. However, if vintaging is eliminated so that a supply response will occur for old gas, then new-gas prices will not have to rise dramatically to encourage

[224] For example, in April 1984, INGAA issued a study entitled "Analysis of Price Fly-Up under the Natural Gas Policy Act," in which it stated, "In the absence of significant renegotiation or a legislative solution, non-market sensitive price and take provisions in existing contracts will push the average wellhead price up by 9% to 12% above inflation in 1985." Significantly, the INGAA fix-up prediction was based on the same incorrect assumption made by similar comments in this rulemaking: that producers will automatically collect the highest prices authorized by indefinite price escalators in their existing contracts, despite competitive market conditions.

[225] DOE predicts a dissipation of the surplus by 1988 under current regulations. The surplus could be dissipated by 1987 if vintaging is eliminated because the natural gas market will operate with greater efficiency.

exploration and development since some of the necessary supply response will be obtained through higher prices for old gas. In short, more gas will be made responsive to the market, prices will be more stable, and the tendency toward inefficient price disparities in the natural gas market will be reduced.

Commenters have included numerous studies and statistics in the record concerning the likely impact of the DOE proposal on consumers. To the extent they illustrate the wide mixture of old gas, new gas, and non-market responsive gas on individual pipeline systems, these studies are helpful. Over 20 years of vintaging have splintered the old gas "cushion" into as many pieces as there are different pipeline systems. This unequal access to the cushion means that the Commission must take into account the transitional impacts of the final rule on individual pipeline systems, as well as its long-term impacts nationwide.

However, many of these studies commit the fundamental error of assuming that, on a pipeline-by-pipeline basis, wellhead markets are static and do not change in response to changing city-gate and burner-tip markets. For example, a number of commenters in this docket have assumed that old, flowing gas prices will *immediately and automatically* rise to the highest price permitted by the final rule, but that existing high-cost gas prices will *not* be renegotiated downward commensurately.[226]

These studies beg the question. The real question is not *whether* high-cost prices will come down in response to higher old gas prices, it is *how fast* they will come down. Nor is it a question of the impact of the rule on a *pipeline's* gas acquisition costs *per se*. Instead, the NGA requires the Commission's ultimate concern to be

[226] *See, e.g.*, Initial comments of INGAA, AGA, Northern Natural, Natural Gas Pipeline of America, Panhandle Eastern, Southern Natural, Northwest Central, KN Energy.

protection of *consumers* downstream from the wellhead, and therefore it must seek a balance of risks and return at the wellhead which achieve this goal.

For this reason, the Commission has analyzed the evidence in the record as to how quickly existing wellhead prices, especially those for new gas, can respond to changes in city-gate and burner-tip markets. In addition, the Commission has scrutinized the current and past purchased gas adjustment filings ("PGAs") made by the 20 major interstate pipelines. The most current PGA data, included in the record, breaks down for each pipeline its purchased gas costs by NGPA pricing category, volumes, weighted average cost, and major producer-suppliers. Past PGA data, compiled by EIA, indicates the trend of high-cost prices under NGPA section 102 and section 107 on major pipeline systems between early 1983 and the present.[227]

These tables indicate that high-cost gas WACOGs have trended *substantially downward* since 1985 following the partial deregulation of these wellhead categories mandated by the NGPA on January 1, 1985.

However, because pipelines are only required to file PGAs twice a year, these data do not reflect the full impact of recent falling oil prices on pipeline WACOGs. This decline in oil prices, combined with additional gas-on-gas competition under Commission Order Nos. 380 and 436, is already exerting substantial pressure on pipelines to reduce their WACOGs to marketable levels through out-of-cycle or flexible PGA filings in order to maintain fuel-switchable loads.[228]

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[227] EIA, *Natural Gas Monthly*, *supra* at Table 5 (February 1986).

[228] Pipelines have continued to file for and obtain out-of-cycle or flexible purchased gas adjustments (PGA) authorizations. Listed below are pipelines that have recently obtained a regular PGA at

In addition to PGA data, the Commission has reviewed three studies included or referenced in the record. These three studies all indicate that the most likely impact of the DOE proposal will be further *downward* pressure on consumer prices, as higher old gas prices and additional supplies further accelerate competitive pressures on pipelines and high-cost producers to reduce city-gate prices to market-clearing levels.

The first study, referred to by AGA in its comments, is an "Analysis of High-Cost Gas Purchases by Contract Termination Date." [229] This study (the "Foster Study")

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other than the normal effective date (*), an out-of-cycle PGA (**), or a flexible PGA authorization (***):

Pipeline	*Effective Dates*
ANR Pipeline Co.	8-1-85*, 4-1-86**
Colorado Interstate Gas Co.	5-1-85*, 7-1-85* 9-1-85**, 11-1-85*
Consolidated Gas Supply Corp.	7-1-85*
El Paso Natural Gas Co.	7-1-85*
Florida Gas Transmission Co.	6-1-85*, 2-1-86* 3-1-86**
Mississippi River Transmission Corp.	5-1-85*, 11-1-85*
Natural Gas Pipeline Co. of America	7-1-85*, 1-1-86**
Northern Natural Gas Co.	5-1-85*
Northwest Pipeline Corp.	5-1-85**, 7-1-85*
Panhandle Eastern Pipe Line Co.	6-1-85*
Southern Natural Gas Co.	5-1-85*
Tennessee Gas Pipeline Co.	8-1-85*, 9-1-85** 11-1-85*
Texas Gas Transmission Corp.	12-1-85*, 7-1-85**
Texas Eastern Transmission Corp.	3-1-85*, 7-1-85** 12-1-85**, 4-1-86*
Transcontinental Gas Pipe Line Corp.	4-1-86**
Trunkline Gas Company	3-1-86*
United Gas Pipe Line Co.	11-1-85*
East Tennessee Natural Gas Co.	4-11-86***
Florida Gas Transmission Co.	3-28-86***
Midwestern Gas Transmission Co.	4-11-86***
Northwest Pipeline Corp.	4-25-86***
Tennessee Gas Pipeline Co.	5-2-86***
Transwestern Pipeline Co.	3-28-86***

[229] Foster and Reddick, "Analysis of High Cost Gas Purchases by Contract Termination Date," *Gas Energy Review* (Vol. 13, No. 12, American Gas Association, December 1985).

was prepared by Foster Associates, Inc., on behalf of AGA, and reviewed PGA data as of mid-1985 in order to estimate the volume, producing area, contract execution date, and average price of NGPA section 102 and section 107 gas purchases with projected prices greater than \$3.80 per MMBtu. The \$3.80/MMBtu price is the Btu-adjusted section 102 ceiling price, and was selected to represent the minimum price under contracts without market-responsive terms.

The Foster Study found that the 1.6 Tcf of gas purchased at an average price of \$4.49/MMBtu, or 17 percent of major interstate pipelines' annual domestic purchases of 9.2 Tcf, constituted purchases under pre-1982 section 102 and section 107 contracts with non-market-sensitive terms. In contrast, only 0.7 Tcf of these pre-1982 section 102 and section 107 purchases were found to be market-sensitive, at an average price of \$3.12/MMBtu.

Of the 1.6 Tcf in non-market sensitive contracts, 52 percent was found to be produced on the OCS, while Texas and Louisiana on-shore each represented only 10% of the high-cost production.

On the other hand, the Foster Study found only 0.2 Tcf, or 20 percent, of post-1982 section 102 and section 107 contracts were non-market sensitive. The Foster Study found that 13 percent of so-called "high-cost" gas contracts were pre-1977 in vintage, and thus were likely to be "multiple vintage" contracts also covering volumes of old, flowing gas.

This data indicates that some 1.8 Tcf of high-cost gas may not be subject to express "market-out" authority on the part of the purchaser. On the other hand, this 1.8 Tcf represented only 33 percent of all 5.4 Tcf of "new" and "high-cost" gas volumes purchased by interstate pipelines in 1985.[230] The composite price of these total volumes

[230] EIA, *Natural Gas Monthly, supra* at Table 5 (February 1986).

fell from \$4.00 per Mcf to \$3.37 per Mcf between January 1985 and February 1986.[231] Nor does the Foster Study indicate how much gas under such "non-market responsive contracts" is being "released" from its contract terms and being taken by pipelines at market-responsive prices under the so-called "release" program. This indicates that, notwithstanding their volumes of non-market responsive "new gas," pipelines nonetheless have had sufficient leverage on the rest of their gas costs to reduce overall "new" gas prices over 1 percent a month over the last 14 months—at an overall savings of over \$3.4 billion in gas costs.[232]

The second study, submitted by AGA in its initial comments is AGA's "1986 Base Case," an economic model which projects natural gas prices, supply, and demand over the short-term and long-term. The Commission notes that this study ("AGA Base Case") was published January 17, 1986, and, therefore, assumes oil prices of \$25/barrel in 1986 and 1987, an assumption that understates the downward pressure of falling oil prices on pipeline WACOGs. AGA's recent up-date on the impact of falling oil prices concludes that under the \$15 per barrel scenario, the average field acquisition costs of gas will decline from \$2.58 per Mcf in 1985 to \$1.37 by 1987. The "1986 Base Case" and its updates are based on a system of computer models providing a long-run simulation of natural gas supply, transportation and markets. This model, known as the TERA (Total Energy Resources Analysis) system, is maintained by the AGA under the guidance of an industry advisory committee. The "1986 Base Case" utilizes publicly available information from contracts on file at the Commission, and is intended to represent a "most probable" future based on current market and regulatory conditions.

[231] *Id.*

[232] Id.

Table 7, following on page 30,244, excerpted from the "AGA Base Case," contains AGA's projection of the average pipeline acquisition cost of gas between 1984 and the year 2000 *under current regulation.* Figures 1, 2, and 4, following on pages 161-3, contain AGA's up-dated projections on reserves, wellhead prices, and demand based on $15 and $20 per barrel oil prices. Specifically, the first table projects that the average pipeline acquisition cost of so-called pre-1982 "high-cost" gas under NGPA section 102, section 103, and section 107 will decline from $3.79/MMBtu in 1984 to $2.69/MMBtu in 1986, and $2.15/MMBtu by 1988. According to the AGA "Base Case," at pages 9, and 12 and 21:

> . . . Between 1985 and 1987, the proportion of 1977-1981 gas at the higher price level is gradually reduced reflecting lengthy renegotiation of the contracts containing "indefinite escalator" clauses. Some post-1977 gas, especially § 102 "d" gas (from OCS Leases) technically remains regulated. The ceiling price, however, is above the level on the . . . The long term "free market surrogate" level of wellhead prices (without severance taxes and gathering charges) for decontrolled natural gas has been arbitrarily assumed to be 50% of the refinery acquisition cost of crude oil . . . As shown on Table 7, the decline of average retail gas prices from $5.08 per MMBtu in 1985 to $4.33 per MMBtu in 1988 represents a 14% [real] decline within 3 years. The decrease from the 1985 retail prices of $5.08 per MMBtu to $4.59 per MMBtu in 2000 represents a cumulative average "real" price drop of about 10%.

TABLE 7.—NATURAL GAS PRICES [1]

(1985$/MMBtu)

	1984	1985	1986	1988	1990	1995	2000
Natural							
Transmsn Co. Acqstn [2]							
Old Inter [3]	1.21	1.14	1.16	1.16	1.15	1.20	1.18
Old Intra [4]	2.42	2.41	2.18	2.10	2.11	2.33	2.57
New-Old [5]	3.79	3.46	2.69	2.15	2.15	2.36	2.59
New-New [6]		2.54	2.27	2.17	2.17	2.37	2.60
Average [7]	2.65	2.53	2.10	1.87	1.90	2.17	2.46
Transmission	1.32	1.26	1.27	1.24	1.26	1.16	1.12
City Gate [8]	3.97	3.79	3.37	3.11	3.16	3.33	3.58
Total Supply:							
Natural [8]	3.97	3.79	3.37	3.11	3.16	3.33	3.58
Supplemental [9]	4.64	3.99	3.62	3.42	3.38	3.70	3.93
Average	4.01	3.82	3.40	3.14	3.19	3.40	3.66
Distribution							
Residential	2.15	2.00	1.93	1.85	1.82	1.60	1.50
Commercial	1.66	1.62	1.58	1.52	1.49	1.31	1.20
Industrial	.55	.64	.62	.58	.56	.47	.43
Elec. Util. P.P.	.34	.19	.37	.43	.38	.50	.47
Average	1.29	1.26	1.24	1.19	1.17	1.01	.93
Retail Price [10]							
Residential	6.16	5.82	5.33	4.99	5.01	5.00	5.16
Commercial	5.67	5.44	4.98	4.66	4.68	4.71	4.86
Industrial	4.56	4.46	4.02	3.72	3.75	3.87	4.09
Elec. Util. P.P.	4.36	4.01	3.77	3.57	3.57	3.90	4.13
Average	5.30	5.08	4.64	4.33	4.36	4.41	4.59

[1] Reflects prices of gas purchased by the natural gas utility industry and sold to customers.

[2] Includes severance taxes and gathering charges.

[3] Includes sections 104a, 104b, 104c, 106a, and 103"e"/108.

[4] Includes sections 105, 106b, and 103"e"/108.

[5] Supplies attached between 1977 and 1982: Includes sections 102, 102d, 103, 107 tight, and 107 deep.

[6] Supplies attached after 1982: Includes sections 102, 103, 107 tight, and 107 deep.

[7] Reflects changing volumetric mix of various supply categories.

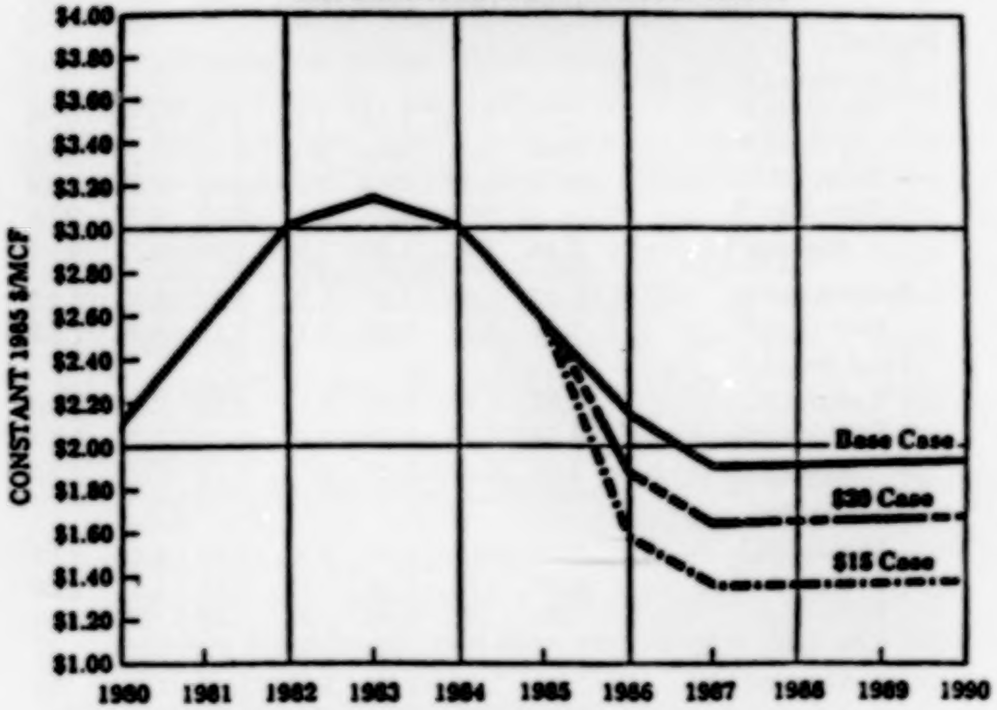
[8] Transmission Company Acquisition Cost plus Transmission Cost.

[9] Includes imports, Alaskan gas, coal gas, gas from new technologies, etc.

[10] City Gate price plus distribution costs.

Figure 1

NATURAL GAS FIELD PRICES UNDER ALTERNATIVE OIL PRICE SCENARIOS*



*Includes inter- and intra-state pipeline acquisitions of gas as well as direct producer consumer transactions.

Figure 3

U.S. NATURAL GAS CONSUMPTION UNDER ALTERNATIVE OIL PRICE SCENARIOS

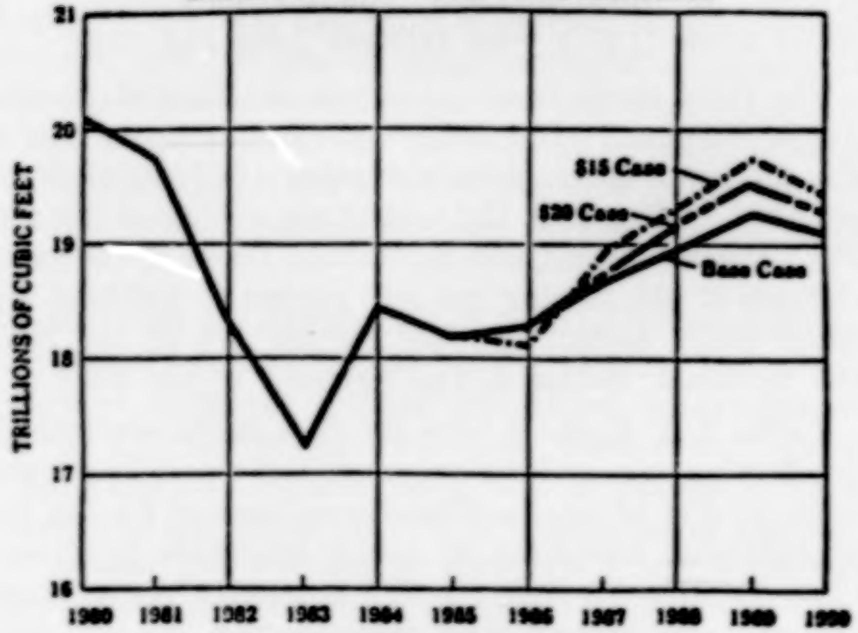
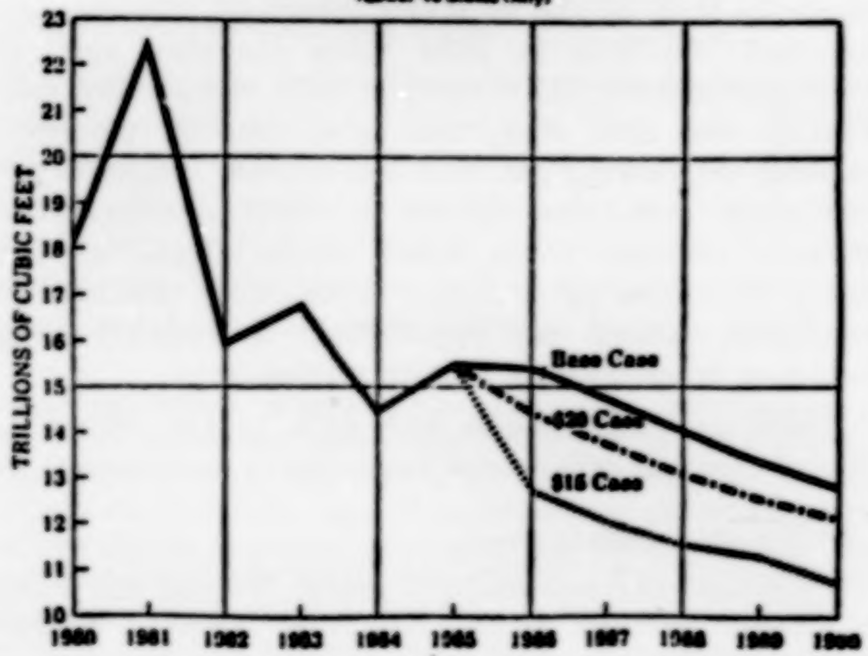


Figure 4

CONVENTIONAL NATURAL GAS RESERVE ADDITIONS UNDER ALTERNATIVE OIL PRICE SCENARIOS

(Lower 48 States Only)



These AGA projections indicate that, even without the pressure of failing oil prices, natural gas markets are expected to force high-cost, "market unresponsive" gas prices down 11% a year between 1984 and 1988.

The third study is an "Analysis of Natural Gas Contracts, Volume I: Old Interstate Gas" prepared by the Energy Information Administration ("EIA") in February 1986.[233] The EIA Old Gas Study evaluated the quantities, average prices, and contractual terms of the various vintages of old, flowing gas still subject to wellhead regulation under section 104 and section 106 of the NGPA and section 4, section 5, and section 7 of the NGA.

Tables 3, 4, 5, and 6 from the EIA study conclude that old, flowing gas under section 104 of the NGPA constituted 3.2 Tcf of total wellhead purchases of 8.4 Tcf from non-affiliated companies by major interstate pipelines in 1984. Of this 3.2 Tcf, 1.1 Tcf is post-1974 gas already subject to the highest MLP under section 104 and priced at an average of $2.49 per MMBtu, while the remaining 2.1 Tcf is priced at $2.12 per MMBtu or below under pre-1974 section 104 vintage prices. The EIA study also concludes that, of the 20 major interstate pipelines, only five had WACOGs in 1984 below the then applicable $2.36 per MMBtu MLP for post-1974 section 104 gas.[234] Finally, the EIA study concludes that 90 percent of existing old, flowing gas contracts contain indefinite price escalators, area rate clauses or other non-market responsive contract terms which could trigger an automatic escalation of contract prices upon wellhead deregulation without any requirement of contract renegotiation or reference to a definite pricing term.

Based on these studies and data in the record, the Commission can make some conservative assumptions con-

[233] EIA Old Gas Study, *supra*.

[234] Colorado Interstate Gas, KN Energy, Natural Gas Pipeline of America, Northern Natural Gas (Now "Enron"), Northwest Central, and Texas Eastern.

cerning the short term trend of new and high-cost gas prices likely under the final rule. If such prices are assumed to continue declining 10 percent a year through 1986 and 1987 (a low estimate compared to AGA's 14 percent per year forecast under $25 oil) then 5.4 Tcf of gas can be expected to decline from an average price of $3.37 in February 1986 to $2.70 per Mcf by January 1, 1988—an overall annual savings in gas cost of $3.63 billion.[235]

On the other hand, 2.01 Tcf of existing old gas volumes are currently priced under NGPA section 104 at an average of $1.61 per MMBtu and below, versus the remaining 1.2 Tcf priced $2.12 per MMBtu and above. We have assumed hypothetically that 90 percent of these volumes will rise to the current average price of the post-1974 section 104 vintage by January 1, 1988—an unrealistically high assumption considering current spot gas prices and the collapse of oil prices. Under this assumption, 1.8 Tcf of old gas currently priced at an overall average of 82 cents per MMBtu would increase to $2.49 per MMBtu by 1988—an overall, hypothetical $3.01 billion in increased old gas costs.

The bottom line under these hypothetical assumptions would be a net *decrease* under the final rule of $620 million in gas costs, an average of 6 cents per MMBtu. However, the Commission considers this a "worst case" scenario because it intentionally *underestimates* the likely dynamic, short-term decline in high-cost gas prices, and *overestimates* the short-term potential increase in old-gas

[235] All calculations regarding the hypothetical price impacts in this section are derived from Tables 3 and 4 of the EIA Old Gas Study, Table 5 of the EIA February 1986 *Natural Gas Monthly*, and the AGA 1986 Base Case. These calculations also adopt the assumption that 90 percent of existing old gas contracts contain sufficient authorization to enable the seller to collect under the new ceiling price in the final rule without further contract modification other than that expressly required by the rule itself.

prices. This analysis also ignores the further downward pressures of collapsing oil prices, consumer access to alternative gas supplies under Commission Order Nos. 380 and 436, incremental supplies of old gas and the "good faith renegotiation" requirements in the final rule.

For example, the Commission has also considered the assumption in the "AGA 1986 Base Case" that average wellhead gas prices decline 14.3 percent annually from 1985 to 1987, and gas acquisition costs reach an average of $1.87 per MMBtu by 1988. Applying these assumptions to the final rule, new and high-cost gas prices would drop an average of 96 cents per Mcf to $2.41 per Mcf. On the other hand, low-priced vintages of old gas would rise an average of $1.05 per MMBtu to $1.87 per MMBtu. Remaining high-priced vintages of old gas would decline from $2.48 per MMBtu to $1.87 per MMBtu. The resulting hypothetical $1.89 billion increase in low-priced old gas costs would be offset by a combined $5.94 billion decline in new gas and high-priced old gas costs—$5.21 billion from new gas and $730 million from high-priced old gas volumes. The bottom line would be a net *decrease* in overall gas costs under the final rule of $4.05 billion, or 41 cents per MMBtu. Again, however, even this hypothetical projection overestimates any increase in old gas prices under the final rule, because the rule prohibits collection under the higher ceiling price unless the existing purchaser agrees to the new price, or unless the producer is able to negotiate a higher price with another purchaser elsewhere *and* can obtain transportation for the gas.

Although the general trend in pipeline and consumer prices is likely to be stable or downward under the final rule, it is impossible to predict with certainty whether some consumers on some pipeline systems may face short-term, transitional increases in their gas costs before the lower overall prices and enhanced supplies are made available to all pipelines under the rule.

For example, some pipelines may have quicker access in renegotiating high-cost gas prices to lower levels than others, even though the national trend is definitely downward. On the other hand, pipelines with large cushions of old gas may be less able to keep their producers from selling old gas elsewhere to higher bidders, precisely because one goal of this rule is to reduce the disparities in wellhead prices that are not attributable to the actual replacement cost of gas in national markets.

Finally, the Commission is aware that some pipelines may be less confident of their ability to renegotiate all gas prices to more competitive levels with their producers, and expecting the worst, may file for projected purchased gas costs based on the worst possible outcome of their negotiations. In this way, they would, in effect, be passing along the risks of their negotiations directly to their consumers. The Commission intends to scrutinize any such PGA filings very carefully, and will exercise its suspension authority liberally to assure that PGAs track actual gas costs as realistically as possible.

Despite these potential risks, the Commission considers that, under this rule, the overall competitive benefits of more accurate price signals, coupled with the long-term benefits of enhanced supplies of existing gas reserves, will outweigh the risks of any isolated price increases to consumers on individual pipeline systems. It is clear that consumers have suffered shortages and higher prices under the current price system for old gas, and these distortions can only cause more damage to consumers in the future, if existing reserves continue to be sold on a basis less than replacement cost. Keeping old gas rates below replacement cost can only revive shortages and high prices for future generations of consumers.

The final rule is not only intended to balance the interests of present consumers and present producers, it is intended to balance the needs of future consumers for

long-term reliable gas service, with the protection of present consumers from exploitation by producers.

The Commission has chosen to price old gas at its replacement cost, while at the same time requiring producers and pipelines to go through the "good faith negotiation" procedures before collecting any higher prices. This balances the revenue needs of producers to replace reserves with the interests of consumers in assuring that all wellhead prices are subject to the maximum benefits of competition, mandated by the NGPA. The final rule achieves this balance in two ways:

(1) It prevents producers from collecting the higher price for old gas from an existing pipeline purchaser unless the purchaser expressly agrees; and

(2) It allows producers to sell their old gas to anyone in competitive welhead markets under the new price, as long as they first have offered the gas to their existing purchaser and have completed the "good faith negotiation" process in which the purchaser can renegotiate its gas prices with the producer.

The Commission has also reviewed the recent conclusions of the Energy Information Administration (EIA) regarding the likely price impacts of the DOE proposal.[236] EIA independently reviewed the question of whether high-cost contracts are inflexible downward so that removal of controls on low-priced old gas would cause that gas to rise in price without any offsetting downward movement of high-priced gas. The source of data reviewed by EIA was purchased gas adjustment filings of selected interstate pipelines at the Commission during the first half of 1986, separated out by NGPA price category and contract year. EIA concluded:

[236] "An Analysis of the Department of Energy's Notice of Proposed Rulemaking (NOPR), 'Ceiling Prices: Old Gas Pricing Structure'", *Service Report*, Energy Information Administration, May 1986 (RNGD-86-03).

> A review of new gas contracts indicates that high-priced gas is flexible downward in all NGPA sections and for all vintages . . . Whatever their respective contracts stipulate, the wellhead prices of natural gas can be overwhelmed by market forces and that is precisely what is happening in the market today. Thus, current apprehensions concerning a perceived lack of downward price mobility are unfounded, just as earlier apprehensions about a 1985 gas price fly-up were unfounded.[237]

The Commission especially notes EIA's conclusions concerning the price flexibility of pre-1982 section 102 new gas contracts, the category considered by pipelines to be the most troublesome. According to EIA's review, "As might be expected, the new vintage Section 102 prices lead the decline, but even the oldest (1978-1981) vintage Section 102 prices exhibited *surprising downward flexibility*."[238] (emphasis added)

Figures 1-6, 1-7, and 1-8 from the EIA study which graphically represent the trend in high-cost gas contract prices, are not printed in the *Federal Register* but are available from the Federal Energy Regulatory Commission.

The EIA study also reviewed the short-term and long-term price impacts of the DOE proposal, based on $20 per barrel world oil prices and implementation of nondiscriminatory transportation under Order No. 436. EIA based these price impact estimates on a base case forecast of gas markets, in which it is assumed that real world oil prices equal $20 per barrel from 1986 to 1995, supply and demand elasticities (e.g. fuel switching) are consistent with the model used in EIA's *Annual Energy Outlook*, and Order No. 436 is implemented aggressively and generically. In the short-term, EIA concluded,

[237] *Id.* at p. v.

[238] *Id.*

. . . Since most old interstate gas is currently priced below the average U.S. wellhead price, the addition of such gas will put downward pressure on prices . . . It is EIA's judgment that, if implemented generically, Order 436 would create sufficient competition in gas markets to drive the average price down to near the level of the current spot market, a decrease of about $.30 per Mcf in 1986-1988. Based upon historical experience, this decrease would increase demand by about .25 Tcf per year and thus cause the gas bubble to be drawn down earlier, probably before 1990. The effect of FERC Order 436, coupled with the shrinking of the current gas bubble, is to *keep wellhead prices below $2.00 per Mcf through 1990.*[239] (emphasis added)

Over the long-term EIA concludes that 28 Tcf of additional gas supplies would be stimulated by the DOE proposal, beginning after the "bubble" of surplus gas deliverability disappears in 1990. If these supplies are produced over a 20-year period, about 1.5 Tcf would reach the market each year. According to EIA, these additional supplies brought on-line under the DOE proposal would keep wellhead prices throughout the 1990s at $.35 per Mcf lower than the price of natural gas without the additional supplies. By 1995, the average wellhead price of natural gas would be $2.91 per Mcf under the DOE proposal, compared to $3.26 per Mcf without the proposal.[240]

EIA's supply enhancement estimates are based on an independent reservoir engineering study it applied to field-specific data available for 557 Texas gas fields under a stipulated wellhead price of $2.50 per Mcf, in order to estimate the effects of delayed abandonment. EIA also estimated infill drilling recovery, on the basis of a

[239] *Id.* at pp. viii-ix.

[240] *Id.* at pp. 43, 45.

thorough review of a sample of five specific gas fields which already were expected to yield 75 percent of the additional supplies projected for delayed abandonment. Finally, EIA accepted the estimates of other studies as to the potential recovery of 6 Tcf by well stimulation.

The Commission notes that, under $20 per barrel oil prices and even without Order No. 436, EIA projects that average wellhead prices will decline over 5 percent per year, from $2.60 per Mcf in 1985 to $2.07 per Mcf in 1988. When the impact of Order No. 436 is factored in, EIA estimates average wellhead prices will decline nearly 8 percent per year over the short-term, from $2.60 per Mcf in 1985 to $1.80 per Mcf in 1988.[241]

For these reasons, the Commission concludes that the final rule will not unreasonably increase consumer gas prices over the short-term, and over the long-term will reduce city-gate gas prices in response to competitive wellhead markets and enhanced recovery of old gas supplies.

F. *Good Faith Negotiation Rule.*

Producers may collect the new ceiling price only to the extent permitted by their contracts. Indefinite price escalation clauses in existing contracts provide the necessary contractual authority.[242] However, the Commission believes that producers with indefinite price escalation clauses should not automatically receive the new ceiling price. Otherwise, the ceiling price would become a floor and that would distort the market as much as current artificially low ceiling prices. Therefore, the Commission will require that parties to existing contracts who do not voluntarily negotiate a new or amended contract price, comply with a "Good Faith Negotiation Rule" before raising the price above current ceiling prices. By allow-

[241] *Id.*

[242] The record indicates that 85 to 90 percent of old gas contracts have indefinite price escalation clauses.

ing each party to assess the value of the old gas in light of competition and other market forces, that rule should prevent old-gas prices from rising above market prices.

The Commission generally adopts the good faith negotiation rule proposed by DOE in its NOPR. However, in order to provide more balanced negotiating rights among the parties, the Commission modifies DOE's proposed rule so that when a producer seeks a higher price for old gas in one contract the purchaser may seek a lower price for all gas (both old and new) in any contract between the parties containing any old gas. This should result in an old gas being priced at the lower of the market or the ceiling price and eliminate the possibility that a purchaser under a multi-vintage contract could be required to continue purchasing the high-cost new gas while the purchaser abandons sales of the low-cost old gas. In addition, this modification should significantly assist in bringing down the price of high-cost gas, including that sold under non-market responsive contracts. The Commission also makes certain other changes in the good faith negotiation rule.

Comments. In the NOPR, DOE proposed that each producer be given a one-time right, exercisable at any time, to request the existing purchaser of old gas under a contract in effect on July 1, 1986, to nominate within 60 days the price the purchaser is willing to pay for the gas. If the existing purchaser refuses to nominate a price, the producer would be free to sell the gas to a new purchaser and would be released from all obligations in law and contract to the existing purchaser upon 30 days written notice that a new purchaser had been found. In the interim, however, the producer would be required to continue to sell the gas to the original purchaser at the existing contract price.

If the purchaser nominates the highest price permitted by the existing contract (in most cases the post-1974 MLP), the producer would be required to sell the gas

to the purchaser at that price. If the purchaser nominates a price less than the highest price permitted by the contract, the producer would have 30 days to indicate whether it accepts or rejects the nominated price. If the producer accepts the nominated price, the producer would be required to sell the gas to the existing purchaser at that price. If the producer rejects the nominated price, the producer would be free to sell the gas to a new purchaser who offered to pay a price higher than the nominated price for a term of at least two years. Once a new purchaser is found, the producer would be released from all obligations in law and contract to the existing purchaser upon 30 days notice. However, in the interim the producer would be required to continue to sell the gas to the existing purchaser at the existing contract price.

Pipeline, distributor and consumer commenters contend that the DOE good faith negotiation rule is illegal and unsound in policy.[243] First, they contend that the

[243] Northwest Central Pipeline Corporation at 13-15, 18-19; Columbia Gas Transmission Corporation at 7; ANR Pipeline Company at 4-5; KN Energy Inc. at 10-11; Kansas Power & Light Company at 14-16; Public Service Commission of West Virginia at 10-11; Transcontinental Gas Pipe Line Corporation, at 5-7; Texas Eastern Transmission Corporation at 23-25; Natural Gas Pipeline Company of America at 14-16, 34-36; Baltimore Gas & Electric Company at 3-4; El Paso Natural Gas Company at 6-10, 16-17; Public Utilities Commission of California at 31-34; Southern California Gas Company at 19-21; Interstate Natural Gas Association of America at 21-24; Tennessee Gas Pipeline Company at 819, 19-23; Peoples Gas Light and Coke Company and North Shore Gas Company at 13-15; Northern Illinois Gas Company at 7; Panhandle Eastern Pipe Line Company and Trunkline Gas Company at 13-16, 25; Southwest Gas Corporation at 6; Minnesota Department of Public Service at 6; Dorchester Hugoton at 7; American Public Gas Association at 62-73; Rochester Gas and Electric Corporation at 25-27; Illinois Commerce Commission at 15-16; Consumer Advocate Division of Public Service Commission of West Virginia at 7-8; E. I. DuPont de Nemours & Company at 14-19; Delhi Gas Pipeline Corporation, reply comments at 2-4; American Gas Association, reply comments at 18-23; People's Gas System

provision of the good faith negotiation rule releasing the producer from all obligations in law to the purchaser if the purchaser fails to nominate an acceptable price grants producers blanket abandonment in violation of NGA section 7(b). Producers sell old gas under certificates of public convenience and necessity issued under section 7(c) of the NGA. Therefore, they may not terminate sales without abandonment authorization from the Commission pursuant to section 7(b) of the NGA. Section 7(b) permits the Commission to grant abandonment only after a hearing and a finding that abandonment is warranted because the available gas supply is depleted or the present or future public convenience or necessity warrant the abandonment. The opposing commenters argue that the good faith negotiation rule would permit abandonment without the necessary hearing or finding that abandonment is in the public interest.

Opposing commenters also contend that the good faith negotiation rule violates the *Mobile-Sierra* doctrine and section 5(a) of the NGA. In *United Gas Pipe Line Co. v. Mobile Gas Corp.*, 350 U.S. 332 (1956), the Supreme Court held that a natural gas company may not unilaterally change its contract. The court further stated that a producer dissatisfied with the existing contract rate may obtain relief only through an NGA section 5(a) proceeding in which the Commission may, after a hearing and based on substantial evidence, determine the existing rate to be unjust and unreasonable. Commenters argue that, contrary to the *Mobile-Sierra* doctrine, the good faith negotiation rule allows a producer unilaterally to abrogate its contract if dissatisfied with the price nominated by the purchaser without the hearing or findings required by section 5(a) of the NGA.

Inc., reply comments at 9-10; United Distribution Companies, reply comments at 47-56; American Gas Association at 3, at 10-11, 27-31; Texas Independent Producers and Royalty Owners Ass'n at 6-7; Northern Natural Gas Company at 3, 5; Northwest Pipeline Corporation at 6-13.

Finally, the opposing commenters argue that the good faith negotiation rule is unduly weighted in favor of producers. By permitting producers who do not get a satisfactory offer from purchasers unilaterally to walk away from their contracts, the rule allegedly would require purchasers to bid the maximum lawful price or face the loss of formerly "low-cost" gas supplies. Commenters contend that as a result the proposed rule's new ceiling price for gas will become the floor.[244] Some opposing commenters also contend that the good faith negotiation rule leads to particularly unfair results with respect to multi-vintage contracts. In such contracts the purchaser may have agreed to a relatively high price for new gas in reliance upon the old gas being priced at or less than current ceiling prices. However, the good faith negotiation rule would permit the producer to seek a higher price for the old gas and, if dissatisfied with the price offered by the purchaser, abandon the sales of the old gas while requiring the purchaser to continue purchasing the high-cost new gas.[245]

Producer commenters and DOE contend that the rule as proposed does not violate NGA section 7 since the requirement of a hearing before granting abandonment is satisfied by the hearing and comment procedure provided in this rulemaking proceeding and automatic abandonment under the good faith negotiation rule is in the public interest. Furthermore, these commenters contend that the good faith negotiation rule does not allow producers unilaterally to change or abrogate contracts where the pipeline refuses to agree to a new higher contract price desired by the producers. Instead, there would be a bilateral agreement not to continue under the existing contract and its existing authority to collect the higher ceiling price without renegotiation. Therefore, there is no

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[244] *See*, for example, INGAA at 22-24.

[245] *See Northwest Pipeline Corporation* at 10-11.

violation of the *Mobile-Sierra* doctrine. Finally, these commenters contend that the good faith negotiation rule is not duly weighted in favor of the producer but provides for balanced negotiation.

In their comments supporting the DOE proposal, Indicated Producers present a modified good faith negotiation procedure designed to avoid the legal challenges raised by parties opposing the DOE rule. Under this proposal, the Commission would impose a moratorium on rate increase filings for old gas subject to the new ceiling price until one of three conditions is met. The first condition would be that the producer files a new or amended contract together with a petition requesting authorization to collect the applicable contract rate, up to the new maximum lawful price. The second condition would be that the producer files for collection of the applicable contract rate, up to the new maximum lawful price, together with an agreement by the purchaser that the moratorium be lifted. The third condition would be that the producer files an application for abandonment of the sale of the gas and tenders to the purchaser a release from the contract for the gas which is the subject of the abandonment application. If this is done, the producer could simultaneously file for collection of the applicable contract rate agreed to by a third party, up to the new maximum lawful price, and would be entitled to collect this rate from the original purchaser until abandonment is granted. The pipeline and its customers could either contest the abandonment application or support it and accept the release offered by the producer.

Indicated Producers argue that the modified proposal will give pipelines as well as producers compelling economic incentives to renegotiate their contracts in order to provide for market-responsive old-gas prices while avoiding possible legal infirmities in the good faith negotiation rule proposed by DOE. The Natural Gas Supply Association (NGSA) supports Indicated Producers' proposed modification of the good faith negotiation rule.

Commission Response. The Commission rejects opposing commenters' contentions that the grant of abandonment to a producer if the purchaser fails to nominate a price or mominates an unacceptable price violates NGA section 7(b). The Commission finds, based on the present record, that the present and future public convenience or necessity permit abandonment in such circumstances. Granting abandonment where the existing purchaser fails to make an acceptable offer is in the interest of the market as a whole.[246] This abandonment is necessary to ensure that all old gas, with its relatively low production cost, can obtain the market-responsive prices permitted by this rule. Without the possibility of abandonment, the purchaser could simply insist on a continuation of the present price. Only through such higher prices will increased production through delayed abandonment occur, as described in section I VD, *supra*. The resulting increased supply of old gas will displace higher-cost gas, create more competition in the market place, and thus bring down overall prices as described in Section IV E, *supra*.

The Commission also finds without merit the opposing commenters' contention that the good faith negotiation rule's provision for abandonment violates NGA section 7(b)'s hearing requirement. That hearing requirement is satisfied by the hearing and opportunities to comment provided in the present rulemaking. Section 7(b) does not require that the Commission hold individual case-by-case hearings.[247] The Commission has determined in this

[246] In *Felmont Oil Corp. and Essex Offshore Inc.*, 33 FERC ¶ 61,333, at p. 61,657 (1985), the Commission announced a change in its abandonment policy, stating that there would be "a shift in the identification of the public interest, from the interest of only specific customers to the interests of the market as a whole."

[247] *See Phillips Petroleum Co. v. FPC.*, 475 F.2d 842, 848-852 (10th Cir. 1973), and *American Public Gas Ass'n. v. FPC*, 567 F.2d 1016, 1064-1067 (D.C. Cir. 1977), holding that the Commission may establish area and national rates in rulemaking pro-

proceeding that the public interest permits abandonment of old gas wells in cases where a purchaser fails to nominate an acceptable price. Therefore, it would make no sense for the Commission to require individual producers to file abandonment applications and to hold a hearing on each application. Since there are thousands of producers of old gas, that procedure could result in a vast proliferation of hearings. Given the Commission's limited resources, the inevitable result would be lengthy delays before individual abandonments could be granted. This would seriously impede the achievement of this rule's goals of increasing production of old gas and reducing overall prices. As the Supreme Court said in *Texaco v. FPC*, "We see no reason why under this statutory scheme the processes of regulation need be so prolonged and crippled."[248] Accordingly, the Commission holds that where the purchaser fails to nominate a price, or nominates a price which the producer rejects, the producer is granted abandonment upon 30 days notice.[249]

Second, the Commission rejects the opposing commenters' contention that the good faith negotiation rule permits producers unilaterally to change or abrogate contracts in violation of the *Mobile-Sierra* doctrine and section 5(a) of the NGA. This contention is based on a misunderstanding of how the good faith negotiation rule works. As DOE and supporting commenters observe, the producer cannot alter the contract in any way under the good faith negotiation rule. It can obtain a higher price only if the existing contract already provides for such higher price through an indefinite price escalation clause. Furthermore, the purchaser has an absolute right to continue the existing contract if it is willing to pay the highest price permitted in that contract. However, as a condition to obtaining a higher price under the contract, the producer must give the purchaser an opportunity to seek a lower price under that contract and certain other contracts, or terminate the contracts if it is unwilling to pay the contract price or such lower price as the producer is willing to accept. The producer is required to give the purchaser this right in order to prevent indefinite price escalation clauses in existing contracts from automatically raising the price to the new ceiling price. In the case of other old gas for which the purchaser affirmatively requests a lower price or other categories of gas under a multi-vintage contract containing old gas, again, the pipeline, not the producer, is initiating the renegotiation process, and only as a condition precedent to the producer being authorized to collect a higher price under an existing contract pursuant to an indefinite escalation clause. Thus, only the purchaser, not the producer, has a right to terminate the contract, and the purchaser has that right only because the producer has chosen to give it to him. There is, therefore, no violation of the *Mobile-Sierra* doctrine. To the extent the Commission must, pursuant to NGA section 5, hold a hearing and find that the existing rate is unjust and unreasonable before the producer can obtain a rate higher than the present rate, the Commission has in the present proceeding already made such a finding after a hearing. *See* Section IV B, *supra*.

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ceedings as opposed to case-by-case adjudications without violating the similar hearing requirements of NGA sections 4 and 5. *See also, FPC. v. Moss*, 424 U.S. 494, 500-501 (1976), stating that the Commission has discretion to determine the timing of its finding that the public convenience or necessity permit abandonment, including the discretion to pre-grant abandonment on a generic basis even though years may elapse before the abandonment actually occurs.

[248] 377 U.S. at 33, 44 (1964). *See also, Phillips Petroleum Co. v. FPC*, 475 F.2d at 849, 851, citing *Permian*, 390 U.S. at 777, holding that the Commission has broad discretion to contrive expeditious administrative methods in order to achieve its regulatory purposes.

[249] As explained in more detail later, *infra* at pages 196-199, the abandonment will be limited to the old gas wells for which the producer sought a higher price.

The Commission generally disagrees with the opposing commenters' contention that the good faith negotiation rule, as proposed, is unfairly weighted in favor of producers and would result in pre-1975 gas escalating to the new price ceiling while no other gas would come down in price. As explained in Section IV E, the Commission believes that competitive forces in the natural gas market, including competition from alternative fuels, would prevent this from happening. However, the Commission does agree that the rule as proposed could be unbalanced in two respects. First, the rule provides only for the renegotiation of old gas contracts with below-market prices and does not permit purchasers to obtain the renegotiation of old gas contracts with above-market prices. For example, if a producer and purchaser had two contracts, one covering primarily pre-1973 flowing gas and the other covering primarily post-1974 gas, the producer could seek a higher price only for the first contract. There would be no way for the purchaser to seek a lower price for the post-1974 old gas in the second contract under the good faith negotiation rule even though the post-1974 ceiling price may be above the current market price for gas.

Second, the Commission agrees with the contentions of opposing commenters that the good faith negotiation rule, as proposed, could be unbalanced in its treatment of multi-vintage contracts. For example, if a contract included both old and other gas, the producer could seek a higher price for the old gas but the purchaser could not seek a lower price for the other gas. If the producer was not satisfied with the price nominated by the purchaser for the old gas, the producer could terminate sales of the old gas to the purchaser, sell that gas to a third party, but require the purchaser to continue purchasing the other gas. Yet the purchaser may have agreed to the high price for the other gas in reliance on the fact the low cost of the old gas lowered the average price under the contract to reasonable levels.

In order to cure these inequities in the operation of the good faith negotiation rule as proposed and to assure that purchasers will have the ability to substantially reduce their cost of purchasing high-cost gas, the Commission will modify the good faith negotiation rule as follows. If a producer makes a nomination request with respect to old gas in one contract, the Commission will permit the purchaser to seek a lower price for any gas, whether old or new, in any contract between the parties which contains some old gas. In the event the producer and purchaser cannot agree on a new price for the gas for which the purchaser made a nomination request, the purchaser shall have the right to terminate its purchases of that gas under the contract in question.[280] If the purchaser exercises this right with respect to gas subject to the Commission's NGA jurisdiction, the Commission will also permit abandonment. The public convenience and necessity permits that abandonment for the same reasons discussed above with respect to the producer's abandonment of sales of below-market old gas and because the

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[280] This would, of course, include a right for the purchaser to terminate purchases of some gas removed from the Commission's NGA jurisdiction. *Pennzoil Co. v. FERC*, 645 F.2d 360 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982), holding that the Commission can no longer interpret contracts that cover gas removed from the Commission's NGA jurisdiction, does not prevent the Commission from requiring that producers provide purchasers this opportunity under the good faith negotiation rule. The Commission is acting pursuant to its authority under NGPA sections 104(b)(2), 106(c), and 501(a) to condition the producer's eligibility to obtain a higher price for jurisdictional old gas under the good faith negotiation rule on its giving the purchaser an opportunity to renegotiate all gas under multi-vintage contracts containing any old gas. *Shell Oil co. v. FPC*, 520 F.2d 1061, 1077 (5th Cir. 1975), supports the Commission's authority to condition collection of a new just and reasonable ceiling price under NGPA sections 104 and 106 on a contractual *quid pro quo*. *See also*, *Pennzoil Co. v. FERC*, 671 F.2d 119, 127 (5th Cir. 1982), holding that the Commission may place such condictions on eligibility for ceiling price as are "reasonably calculated to further [the Commission's] legitimate regulatory policy."

purchaser is no longer taking the gas. Permitting the purchaser to seek a lower price for all gas in any contract containing any old gas will enable purchasers to bring down the cost of all above-market old gas and the cost of any other above-market gas in multi-vintage contracts. This should substantially reinforce the purchaser's ability to reduce its cost of purchasing high-cost gas, including that sold under non-market responsive contracts.[251]

The Commission also modifies the good faith negotiation rule so as to eliminate the requirement that any contract the producer enters into with a third party after rejecting the price nomination by the purchaser be for a higher price and a term of at least two years. The Commission believes that these requirements would be contrary to the goal of making natural gas contracts more market-responsive. The two-year requirement effectively prohibits market-out clauses for a period of two years. Most new contracts contain such clauses and such clauses have been instrumental in permitting pipelines to reduce their purchased gas costs in recent years. Also, both the two-year and higher price requirements seem unfair and unnecessary in light of the increased bargaining rights the Commission has given the purchaser with respect to above-market old gas and to other gas in multi-vintage contracts. Finally, the higher price requirement is also unnecessary since it is extremely unlikely the seller would sell gas for less than the price it could obtain from the original purchaser. Furthermore, the final rule provides

[251] *See* the more detailed discussion of this matter, *supra* at 149-150.

The Commission will also deem any pipeline which has not accepted Order No. 436 to have agreed to transport gas whose sale has been abandoned or released by either the producer or the pipeline under the good faith negotiation rule to any existing customer of the pipeline or another pipeline interconnected with the first pipeline. This matter is discussed in more detail in section VI D.

the firm sales customers of the original purchaser with a right of first refusal of any offer to sell the gas to a new purchaser.

For the reasons described above, the Commission believes that the good faith negotiation rule, as modified, provides for balanced negotiation between the parties. In addition, the Commission finds unconvincing the contention of opposing commenters that the good faith negotiation rule would require purchasers to nominate the new ceiling price for old gas since otherwise they would risk loss of that gas. The good faith negotiation rule is designed to benefit purchasers by giving them a right, not generally provided by their contracts, to seek a price lower than that which the contracts would otherwise require them to pay. Any assertion that this right is illusory overlooks the substantial incentive producers have to reach an agreement with the existing purchaser. The producer is unlikely to sell to another purchaser unless it finds one willing to offer a better bargain than the existing purchaser. In today's market that may be difficult. Until the producer commences sales to an alternative purchaser, it must continue sales to the original purchaser at the old low prices. Also, the purchaser's right under the modified good faith negotiation rule to terminate purchases of above market gas, whether old or new, in any contract containing any old gas gives the purchaser an additional strong bargaining card in any negotiation with the producer. In light of these pressures on the producer to negotiate in good faith, it is unreasonable to believe that, in today's competitive market, pipelines will feel constrained to nominate the ceiling price in order to avoid loss of old gas. The fact that pipelines are currently marketing out on all categories of gas at prices less than the post-1974 ceiling price (see table 2 at page 143) further supports the Commission's belief that pipelines will not automatically nominate the ceiling price.

Some commenters contend that a pipeline's sales customers may be harmed when old gas sales to that pipeline are abandoned under this rule. The pipeline's customers may have relied on the pipeline's continued access to that gas, pursuant to the producer's NGA service obligation, as insuring that they had access to an adequate supply of gas at reasonable prices. The commenters contend that the pipeline's loss of the gas may increase the pipeline's system supply sales costs, thereby harming the pipeline's firm customers.[252] The Commission believes that generally a pipeline's customers will not suffer higher prices under this rule. As explained in Section IV E, *supra*, the Commission believes that competitive pressures, including competition from alternative fuels, will create strong pressures on pipelines to take such actions as are necessary to keep their WACOGs down in order to avoid loss of market.

However, in order to afford additional protection to the pipeline's customers, the Commission makes a further modification in the good faith negotiation rule. The Commission will require that, whenever gas is released under this rule and the existing purchaser is not an Order No. 436 transporter, the producer may not sell gas subject to the Commission's NGA jurisdiction to anyone other than the pipeline's firm sales customers until it has given those customers a right of first refusal. If the seller makes an offer to a third party encompassing non-jurisdictional, as well as jurisdictional gas, the right of first refusal will apply to the entire offer. The right of first refusal would give the firm sales customers an opportunity to purchase the gas under the identical terms agreed to between the producer and the third party. If more than one firm sales customer accepts the third

[252] In particular, some commenters fear that off-system purchasers, such as large industrial users, could outbid the pipeline for the gas since they generally do not have the take-or-pay obligations for new gas that many pipelines have and that this would cause the pipeline's system supply sales cost to rise.

party offer, the producer may at its discretion choose which firm sales customer it will sell the gas to. The pipeline is deemed to agree to transport the gas to the firm sales customers.[253] There is no need to provide the firm sales customers a right of first refusal when their pipeline is an Order No. 436 transporter, since the customers of an Order No. 436 pipeline could purchase gas from any producer connected to that pipeline and have the gas transported to them.

This procedure should enable firm sales customers to purchase any gas abandoned under this rule at a price approximately equal to or less than the pipeline's WACOG.[254] Thus, the firm sales customer's access to adequate supply at reasonable cost is protected.

Finally, the Commission alters the good faith negotiation rule as proposed in one other respect. The Commission provides that no producer may request a purchaser to nominate a price under the good faith negotiation rule until November 1, 1986. This will allow the parties an opportunity to voluntarily renegotiate their contracts before negotiations begin pursuant to the good faith negotiation rule. It will also provide all affected parties an opportunity to familiarize themselves with the operation of the rule.[255]

The following is a summary of the operation of the good faith negotiation rule, as modified. The Commission will illustrate the summary by reference to the following

[253] *See* Section VI D.

[254] The firm sales customer will probably pay more for any abandoned gas than the pipeline paid for that particular gas, but this does not mean the customer will be paying more than it previously paid the pipeline for a comparable amount of gas since the price the customer paid the pipeline represented the rolled-in cost of all the pipeline's gas.

[255] *See* petitions of AGA, AGD, INGAA, and UDC filed May 23, 1986.

example. A producer and purchasers have two contracts. Contract A and Contract B, both existing on the effective date of this rule and both with indefinite price escalation clauses permitting the producer to collect the highest price allowed by law. Each contract provides for the sale of gas from pre-1973 flowing gas wells, post-1974 old gas wells, and new gas wells. However, most of the gas sold under Contract A is pre-1973 flowing gas while most of the gas sold under Contract B is post-1974 old gas and new gas. The good faith negotiation process is initiated by a producer requesting in writing that a purchaser of old gas under a contract or service obligation existing on the effective date of this rule nominate a new price[256] for the old gas. Of course, there must be contractual authority for a higher price, for example through an indefinite price escalation clause. The producer may make a request at any time after October 31, 1986, but no more than once with respect to any particular contract. The producer may also specify the particular old gas wells for which it desires the purchaser to nominate a price.

Thus, in the Commission example, since both contracts existed on July 18, 1986, and contain indefinite price escalation clauses, the producer may request the purchaser to nominate a new price for the old gas in either or both contracts.[257] Therefore, the producer might well

[256] Obviously, the producer's goal would be to obtain a higher price. However, nothing in the rule prevents a purchaser from nominating either the same price currently being paid or a lower price.

[257] The Commission has assumed both contracts existed on July 18, 1986. If one had expired on June 1, 1986 but sales were continuing pursuant to a service obligation, the producer could still make a nomination request so long as the expired contract contained an indefinite price escalation clause. However, if one of the contracts was not entered into until August 1, 1986 that contract could not be renegotiated under the good faith negotiation rule. The contract is considered entered into as of the date it is

choose, initially at least, to make a request only with respect to Contract A since most of the gas covered by Contract B is already at above-market prices. The producer might also specify that the purchaser nominate a new price only for the pre-1973 flowing gas wells in Contract A. Assuming the producer does this, however, it may not subsequently request the purchaser to nominate a price for the post-1974 old gas under Contract A.[258] However, since Contract B has not yet been placed on the negotiating table, nothing would prevent the producer from making a subsequent nomination request with respect to old gas under that contract. For convenience, the Commission will refer to the producer's initial nomination request as "step 1" in the nomination request process under the good faith negotiation rule.

Within thirty days of the producer's request in step 1, the purchaser may request in writing that the producer

executed. The Commission also assumed in the example that both contracts contained indefinite price escalation clauses. There could be more complicated situations. For example, a contract might have an indefinite price escalation clause and cover 1973-1974 Biennium gas. However, the parties may have executed an amendment providing that the gas be sold at a fixed price less than the 1973-1974 Biennium ceiling price for the period May 1, 1986 to April 30, 1987. In this case, the producer may at any time after October 31, 1986 request the purchaser to nominate a new price for the 1973-1974 Biennium gas but such price would only apply starting May 1, 1987 since there is no contractual authority for a higher price before then.

[258] In the Commission's example, the producer has lost nothing by not making a nomination request with respect to the post-1974 gas in Contract A since that gas is already priced at the new ceiling price. However, if the contract had included 1973-1974 Biennium gas and the producer made no nomination request with respect to that gas, the producer would have lost the right to negotiate a higher price for that gas under the good faith negotiation rule. Accordingly, if a producer believes that it could not in present market conditions obtain a higher price for 1973-1974 Biennium gas, as an example, it may wish to postpone making any nomination request with respect to the contract until a later date when it believes market conditions are more favorable.

nominate a new price[259] for any old or other gas sold under the contract covered by the producer's request. In addition, the purchaser may request that the producer nominate a new price for any gas sold under any other contract between the parties which contains some old gas. As is the case with the producer, the purchaser may specify the particular wells both in the contract covered by the producer's original request and in the other old gas contracts for which it desires the producer to nominate a price, but may not subsequently request that the producer nominate a new price for any wells in either contract for which it does not request the producer to nominate a price. Also, the purchaser may include in its request the same old gas wells covered by the producer's request. This constitutes step 2 in the nominating request process under the good faith negotiation rule.

Accordingly, in the Commission's example, where the producer had requested that the purchaser nominate a new price only for the pre-1973 flowing gas in Contract A, the purchaser could request that the producer nominate a new price[260] for any gas in Contract A.[261] In

[259] The producer is free to nominate a higher price than is currently being paid to the extent applicable ceiling prices would not be violated and the contract permits it.

[260] Presumably, the only old gas in those contracts the purchaser would request that the producer nominate a new price for would be the post-1974 old gas and new gas since that is the only gas it could reasonably expect to obtain a lower price for.

[261] If the purchaser believes that some of the gas for which the producer requested it to nominate a price is overpriced, the purchaser may want to request that the producer nominate a price for the same gas. This is because, even if the producer nominated a lower price in response to the producer's request, the producer could reject the nominated price but not terminate sales. In this event, the purchaser would be required to continue purchases at the existing price unless it had requested that the producer nominate a price and rejected the price nominated by the producer. In the latter circumstance, the purchaser could terminate its purchases. Such a situation is perhaps most likely to

addition, since Contract B contains old gas, the purchaser could request that the producer nominate a new price for any gas in that contract. If, however, Contract B had contained only new gas, the purchaser could not request that the producer nominate a new price for the gas in that contract.

Within thirty days of the purchaser's request that the producer nominate a new price for any gas in contracts not included in the producer's original request, the producer may request in writing that the purchaser nominate a new price for any old gas in those contracts. This is identified as step 3 of the nominating request procedure. Thus, if in the Commission's example the purchaser requested that the producer nominate a new price for the post-1974 old gas and the new gas in Contract B, the producer could request that the purchaser nominate a new price for the pre-1973 flowing gas in Contract B. If the producer failed to request that the purchaser nominate a price for pre-1973 flowing gas in Contract B, it could not subsequently make such a request since that contract is now on the negotiating table and a contract may be renegotiated only once under the good faith negotiation rule.

A request by a producer that the purchaser nominate a new price in either step 1 or step 3 will initiate the following procedures. The purchaser will have sixty days from the producer's request to nominate in writing the price it is willing to pay. If the purchaser nominates the highest price permitted by the existing contract (in most cases the post-1974 MLP), the producer would be required to sell the gas to the purchaser at that price under the existing contract. If the purchaser nominates a price less than the highest price permitted by the contract, the producer would have 30 days to indicate whether it accepts or rejects the nominated price. If the

occur with respect to 1973-1974 Biennium gas, which is not included in the Commission's examples.

producer accepts the nominated price, the producer would be required to sell the gas to the existing purchaser at that price under the existing contract. If the producer rejects the nominated price, the producer would be free to sell all the gas to a new purchaser subject to a right of first refusal on the part of the existing firm customers of the existing purchaser. There would be no required term for the new contract, nor any higher price requirement. Once a new purchaser is found, the producer would be released from all obligations in law and contract to the existing purchaser upon 30 days notice. However, in the interim, the producer would be required to continue to sell the gas to the existing purchaser at the existing contract price. If the purchaser failed to nominate a price in writing, the producer's rights would be the same as when it rejected the purchaser's offer.

The operation of these procedures may be illustrated using the Commission's example described above. If in step 1 the producer requested that the purchaser nominate a new price for the pre-1973 flowing gas in Contract A and the purchaser either failed to nominate a price or the producer rejected the nominated price,[262] the producer would be free to sell the pre-1973 flowing gas to another party subject to the right of first refusal of the existing purchaser's firm customers. If the producer found a purchaser for part or all of that gas, the producer could abandon the sales of the gas to be sold to the other purchaser upon 30 days notice.[263] Contract A would, however, remain in effect with respect to all other gas subject, however, to further alteration as a result of any nomination requests made with respect to that contract in other steps of the nominating request procedure.

A request by a purchaser that a producer nominate a new price in step 2 will initiate the following procedures. The producer will have 60 days from the purchaser's request to nominate in writing the price it is willing to accept. The purchaser will have 30 days thereafter to indicate whether it accepts or rejects the nominated price. If the purchaser accepts the nominated price, it will continue purchasing the gas at that price under the existing contracts; if the purchaser rejects the nominated price, it shall be permitted at any time thereafter, upon 30 days written notice to the producer, to discontinue purchases from the wells subject to the nomination request. Pending expiration of the 30 day notice period, the purchaser shall be required to continue its purchases at the existing price under the contract. Once purchases are discontinued, the sales of the gas will be deemed abandoned and the producer will be free to sell the gas to another purchaser.

Accordingly, in the Commission's example, if in step 2 the purchaser requests that the producer nominate a new price for the post-1974 old gas and the new gas in Contracts A and B and rejects the price nominated by the producer for each contract,[264] it may discontinue pur-

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[262] The producer must either accept or reject the purchaser's nomination in its entirety. The producer may not accept the nominated price for half the pre-1973 flowing gas wells but reject the nominated price for the other half. A partial acceptance is the equivalent of complete rejection. Sales continue for all the wells at the existing price, but the producer may abandon the sales upon 30 days notice.

[263] The producer need not abandon all the pre-1973 flowing gas. If it finds a new purchaser willing to pay a higher price for some of the gas, it may abandon the sales of just that gas and continue selling the other pre-1973 flowing gas to the original purchaser at the original price.

[264] The purchaser must accept or reject the producer's offer with respect to gas in one contract in its entirety. Thus, the purchaser could not accept the producer's offer for the post-1974 gas in Contract A but reject the offer for the new gas in that contract. Any attempt to do so would amount to total rejection. The purchaser would continue purchasing all the gas at the existing price subject to its right to terminate all or part of the purchases upon 30-days notice. However, the purchaser could reject the price nominated

chases from some or all of the post-1974 and new gas wells at its discretion upon 30 days notice. Both contracts remain in effect, however, with respect to all other gas, subject to further alteration resulting from other nomination requests made under the good faith negotiation rule.

Whenever any gas previously sold to a pipeline which has not accepted Order No. 436 is abandoned under this rule, the producer must give the pipeline's firm sales customers a right of first refusal before selling jurisdictional gas (or any other gas included in an offer to a third party for the sale of jurisdictional gas) to anyone else. Existing firm sales customers are those as of the date the third party accepts the first seller's offer. The procedures governing the right of first refusal generally track those set forth in 18 CFR § 277.206 governing the right of first refusal which NGPA section 315 requires that seller give existing purchasers of gas removed from the Commission's NGA jurisdiction by the NGPA. Significant differences include (1) that the pipeline must inform the producer of the names and addresses of its firm customers so as to enable the producer to send the third party offer to the firm customers and (2) that the producer has discretion to determine which firm customer to which to sell the gas when more than one accepts the third party offer. If the firm customers reject the third party offer and the producer sells the gas to the third party, no further right of first refusal will arise when the contract with the third party expires or is renegotiated.

A pipline purchaser which has not accepted Order No. 436 is deemed to agree to transport on behalf of any shipper any gas released under this rule to an existing customer of the pipeline or to any pipeline interconnected with the releasing pipeline.

by the producer for Contract A but accept the nominated price for Contract B.

Finally, the parties to any contract shall be free by mutual agreement at any time prior to abandonment under the terms of this rule to extend any deadline for action by either party under the rule and to maintain the status quo during the period of extension. In addition, the parties may, of course, renegotiate a contract at any time without using the good faith negotiation procedures except that such renegotiation of any contract will prevent any subsequent renegotiation of that contract under the good faith negotiation rule.

The Commission recognizes the complexity of the operation of the good faith negotiation rule. However, the complexity of the rule is necessary to provide balanced negotiating rights for both producers and purchasers. The Commission believes that the rule can be applied efficiently, however. The Commission expects that, before invoking the formal procedures of the good faith negotiation rule, the parties will informally consult with one another in an effort to voluntarily renegotiate their contracts. If the parties reach agreement, the good faith negotiation procedures would never be invoked. The parties would simply amend their contract, thereby removing that contract from the application of the good faith negotiation procedure in the future for purposes of this rule.[265] Accordingly, the Commission expects that the formal procedures of the good faith negotiation rule will be invoked only if the parties are unable to reach agreement and one or the other desires termination of some or all sales under a contract.

V. Adoption of the Old Gas Proposal

A. *Ceiling Price and Procedures.*

Sections 271.402 and 271.602 of the Commission's regulations are amended to incorporate the NGPA section

[265] Neither party may invoke the good faith negotiation rule with respect to a contract after that contract has been voluntarily amended after July 18, 1986.

104 post-1974 price as an alternative ceiling price for gas subject to maximum lawful prices under NGPA sections 104 and 106, effective [insert date 30 days after publication in the *Federal Register*]. Producers may collect any price up to the alternative ceiling price based on mutual agreement with their purchasers. The new ceiling price will also be available to producers in cases where the seller and purchaser renegotiate the terms of their existing contract and thus enter into a new contract. There will be no change in applicable Commission rate filing requirements.[266] However, those filing requirements are waived for sales of gas abandoned under the good faith negotiation rule and resold under a blanket certificate.

A new § 270.201 of the Commission's regulations will also be adopted incorporating the good faith renegotiation procedures established by this rule.

B. *Applicability.*

The new alternative ceiling price will be available subject to the terms of this order for any and all sales of gas which would be, absent this rule, subject to existing lawful prices under sections 104 and 106 of the NGPA.

C. *Affiliate Purchases and Pipeline Production.*

Under the NGPA, producers affiliated with interstate pipelines are entitled to applicable NGPA ceiling prices. Under the Supreme Court's decision in *Public Service Commission of New York v. Mid-Louisiana Gas Company*,[267] pipelines are also entitled to NGPA maximum lawful prices for gas which they produce and take into their own system.[268] In both cases, recovery of maximum lawful prices by interstate pipelines is subject to the "affiliated entities" test set forth in section 601(b)(1)(E) of the NGPA. That section provides that the amount paid is deemed just and reasonable if it does not exceed the amount paid in comparable first sales between persons not affiliated with the interstate pipeline. Consistent with existing Commission policy, affiliate and pipeline production will be eligible for the alternative ceiling price established by this rule, subject to the requirements of the affiliated entities test.

D. *Minimum Rate and Fixed Price Gas.*

Minimum rate gas is sold under a contract that provides for a price lower than the minimum rate ($.32 per Mcf in April 1986) and which is thus entitled to the minimum rate as a result of the incorporation by the NGPA of the minimum rate provisions of Commission Opinion No. 749.[269] Fixed price gas is sold under a contract that provides for a fixed price greater than the minimum rate but less than the applicable maximum lawful price. Neither minimum rate nor fixed price contracts provide for automatic escalation to applicable maximum lawful prices.

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[266] Pursuant to sections 154.91-154.94 of the Commission's regulations, large producers are required to maintain their contracts for jurisdictional sales of natural gas on file with the Commission as rate schedules and to file with the Commission notices of any change in rate together with the contractual authority for the change. Section 154.94(h) provides that rate changes that merely reflect application of the monthly inflation adjustment factor can be made on the basis of a blanket affidavit without making rate change filings each month. Section 157.40 provides that small producers, i.e., not affiliated with a major pipeline company and with jurisdictional sales of less than 10,000,000 Mcf of natural gas per year, are exempted from the rate filing requirements described above for sales under their small producer certificates.

[267] 463 U.S. 319 (1983).

[268] The Commission implemented the Mid-Louisiana decision in Order Nos. 391, 49 FR 33849 (Aug. 27, 1984) and 391-A, 50 FR 14374 (Apr. 12, 1985); 18 CFR 270.203 (1985).

[269] 54 FPC 3090 (1975).

The ability of producers under this rule to negotiate increased prices, with recourse to abandonment if agreement is not reached, is predicated on the existence of contractual authority to receive the new ceiling price. Since producers selling gas at the minimum rate or a fixed price below the applicable NGPA ceiling price do not have the required contractual authority, this rule will not provide for automatic abandonment when the purchaser refuses to agree to price increases in such cases. The Commission intends that producers with such contracts be eligible for the new ceiling price, but absent the purchaser's agreement, they must continue selling under their existing contractual arrangements. Accordingly, sellers of minimum rate or fixed price gas will be eligible for the alternative ceiling price only if and to the extent their purchasers agree.

E. *NGPA Section 106(b) Gas—Intrastate Rollover Contracts.*

Pursuant to NGPA section 121(a)(3), most gas sold in intrastate commerce was price deregulated as of January 1, 1985. One of the categories not deregulated is intrastate rollover gas selling under section 106(b) for $1.00 per MMBtu or less on December 31, 1984. Several commenters have suggested that producers of section 106(b) gas subject to continued regulation should be eligible for the new alternative ceiling price.[270]

The Commission perceives no reason why gas sold under section 106(b) contracts should not be eligible for the alternative ceiling price. The Commission does not wish to hinder the integration of the interstate and intrastate markets, which the NGPA was intended to achieve, by fostering unnecessary price disparities between those markets. We note, however, that section 106(b) sales are not subject to Commission jurisdiction under the NGA. The Commission thus has serious doubt as to

[270] Indicated Producers at 70-71; Mesa Operating Limited Partnership.

whether it has authority to prevent automatic escalation of prices under section 106(b) contracts to the new ceiling by imposition of the good faith negotiation rule adopted as part of this order. We agree that producers subject to section 106(b) should not be precluded from receiving the new ceiling. At the same time we do not feel that purchasers should automatically be required to pay the new ceiling by virtue of indefinite price escalator clauses. Accordingly, the alternative ceiling will be applicable to section 106(b) sales, but the question of whether or to what extent 106(b) producers can obtain a higher price up to the ceiling shall be a matter for negotiation between the parties. Purchasers in such cases are not required to pay any price above the existing price unless they agree. We thus adopt the same rule for section 106(b) contracts as we have for minimum rate and fixed price contracts.

VI. Other Issues

A. *Block Billing.*

In its December 20, 1985, notice of procedural schedule, the Commission requested comments on the interrelationship between the block billing proposal in Docket No. RM85-1-000 and the DOE proposal, and whether the respective proposals were mutually exclusive, or might be merged or adopted concurrently. Block billing would require pipelines to bill their customers separately for old gas (Block 1) and new gas (Block 2). Block 1 old gas is gas which was committed to interstate commerce when the NGPA was enacted. This gas is subject to the relatively low price ceilings established by NGPA sections 104, 106(a), and 109. Block 2 new gas is gas whose price has been decontrolled or is subject to the relatively high incentive prices established by other sections of the NGPA. Under the block billing proposal, a pipeline's customers could purchase a specified percentage of the pipeline's Block 1 gas based on their level of purchases during the period 1979-1984.

Most commenters state that block billing and the DOE proposal are mutually exclusive. Producers, producing state representatives, and certain industrial customers assert that the DOE proposal is preferable to block billing on legal and policy grounds and should be adopted in lieu of block billing,[271] while most pipelines, distributors, and consumer commenters argue that the block billing proposal should be adopted rather than the proposed rule.[272] A few commenters reject both the DOE and block

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[271] *See, e.g.*, Indicated Producers at 83-94; NGSA at 23-24; Independent Petroleum Association of Mountain States at 1-2; Interstate Oil Compact Commission at 4-5; IPAA at 6; PGC at 14; Applied Resources International, Inc., Executive Summary at 2-3; Council of Industrial Boiler Owners at 5-6; Chemical Manufacturers Association at 6-10; E.I. duPont de Nemours and Company at 27-29; Council of Energy Resource Tribes at 5; Mesa Operating Limited Partnership at 2; Mobil Oil Corporation, *et al.*, at 7-9; Montana Petroleum Association at 2; Mid Continent Oil & Gas Association at 3; Members of Congress Michael G. Oxley, William E. Dannemeyer, Dan Schaefer, Bob Whittaker, Jack Fields, and James T. Broyhill, letter at 1; Oklahoma Corporation Commission at 58; State of New Mexico at 9-13; Plains Petroleum Company at 18-21; Petrochemical Energy Group at 2-3; Southern Regional Energy Council at 2; Texas Land Commissioner at 2; Texas Railroad Commission at 4; Texas Independent Producers and Royalty Owners Association at 1-4; Texaco Inc. at 5-10; Union Texas Petroleum at 1.

[272] *See, e.g.*, MPC-NASUCA at 19-24; Arkansas Public Service Commission at 8-12; Public Utilities Commission of the State of California at 39-41; Public Service Company of Colorado at 11; Columbia Gas Transmission Corporation at 9-10; Public Service Commission of the District of Columbia at 9; Laclede Gas Company at 6; State of Minnesota at 9; Michigan Consolidated Gas Company at 22-23; Northern Distributor Group at 13; Pennsylvania Office of Consumer Advocate at 11; Peoples Natural Gas Company at 3; Southern California Gas Company at 38; Texas Intrastate Natural Gas Pipelines at 3; Western Gas Interstate Company at 7-8; CLEC at 19-24. Some commenters who prefer the block proposal suggest modifications thereto, such as subdividing block 2 gas still further into market-responsive, and non-market responsive gas, or reallocating the base periods for access to the respective blocks. *See, e.g.*, AGD at 11-12; AGD at 13 adopting AGA comments; Midcon Corporation at 39-40; Consolidated Edison Company of New York at 1; Memphis Light, Gas and Water Division, City of Memphis, Tennessee at 14-15; Public Utilities Commission of Ohio at 7-8; Northern Indiana Public Service Company at 18-22; Northern Illinois Gas Company at 26-28; Public Service Commission of the State of New York at 1; Pennzoil Company and Pennzoil Producing Company at 8-9; Peoples Gas Light and Coke Company and North Shore Gas Company at 23-26; Southwest Gas Corporation at 8; San Diego Gas and Electric Company at 5.

billing proposals.[273] Several commenters suggest that the block billing and the DOE proposal could and should be implemented concurrently,[274] while a few commenters argue that while they could be implemented concurrently, they should not be because of the philosophical and policy differences in the two proposals.[275] Those parties that suggest the proposals could be concurrently implemented provide little guidance as to how this would be accomplished either practically or procedurally.

The Commission concurs with the overwhelming view of parties commenting on this issue that the block billing and DOE proposals are to a large extent mutually ex-

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[273] *See, e.g.*, Northern Natural Gas Company at 11-12; Questar Corporation at 3; Public Service Commission of the State of Wyoming at 1-4. One commenter, UDC at 16, neither opposes nor supports block billing but opposes the DOE proposal.

[274] *See, e.g.*, Illinois Commerce Commission at 17-20; Baltimore Gas & Electric Company at 7; Columbia Gas Distribution Companies at 7-9; Citizens Energy Corporation at 5-6; Consolidated Edison Company of New York, Inc. at 1-2, Pennzoil Company and Pennzoil Producing Company at 8-9.

[275] *See, e.g.*, DOJ at 34, n.71 ("the Commission could . . . consistently adopt both block billing and the DOE proposal.") DOJ believes, however, that block billing would be "obsolete" to the extent the old price cushion will be eliminated. Other commenters, while agreeing that the proposals may lawfully be implemented concurrently, express their preference for the block billing proposal. *See, e.g.*, Arkansas Public Service Commission at 8-12; Public Service Company of Colorado at 8; State of Minnesota at 9; Public Utilities Commission of Ohio at 7-8; Northern Illinois Gas company at 26-28.

clusive and that it is questionable whether they could be combined or if so what the likely consequences would be. However, we will not terminate the block billing proposal at this time. Rather, the Commission will review the matter in light of the operation of this rule in actual practice and will take such further action in Docket No. RM85-1-000 as is found to be reasonable or necessary.

B. *Department of Justice Alternative Proposal.*

DOJ offers a comprehensive alternative to DOE's proposal which would go beyond that proposal to effectively deregulate all natural gas prices. DOJ contends that since the natural gas market is workably competitive, market-based rates will best achieve the Commission's statutory mandate to assure just and reasonable rates. The market will protect consumers from excessive rates while encouraging production of adequate supplies. Accordingly, DOJ proposes that the Commission exercise its authority under NGPA sections 104(b)(2)(B), 106(c), and 109(b)(2) to declare that any price paid for gas subject to sections 104, 106, and 109 is presumed just and reasonable within the meaning of the NGA. The only exception would be where there was fraud, abuse, or other similar conduct. DOJ would require parties to existing contracts with indefinite price escalation clauses to negotiate a new just and reasonable price. It recommends the Commission do this by cancelling any rate schedule currently on file pursuant to an indefinite price escalation clause. Where the parties fail to renegotiate the contract, the producer could seek expedited abandonment, and there would be a presumption that abandonment is permitted by the public convenience or necessity. Similarly, after any existing contract expired, the producer could seek expedited abandonment with a presumption favoring such abandonment.

While the Commission agrees with DOJ that in a competitive market such as that for natural gas, market-

based rates provide the most efficient allocation of resources, the Commission feels constrained to reject the DOJ proposal as beyond its authority. The DOJ proposal amounts to total deregulation of old gas prices. The NGPA does not give the Commission authority to do this. The Commission's authority under NGPA sections 104(b)(2)(B), 106(c), and 109(b)(2) is limited to prescribing "a maximum lawful ceiling price," higher than that otherwise applicable, which is just and reasonable within the meaning of the NGA. Thus, although the Commission can increase existing ceiling prices, Congress nevertheless required that the Commission prescribe some maximum lawful price. DOJ, however, would have the Commission go beyond the prescription of a new maximum lawful ceiling price and effectively remove all ceiling prices. If, as DOJ suggests, all contract prices are presumed just and reasonable, no ceiling price remains.

That Congress did not intend to give the Commission authority to deregulate old gas prices completely is further shown by the NGPA's requirement that the new price be just and reasonable within the meaning of the NGA. The Commission has no authority to deregulate prices under the NGA. As the Circuit Court of Appeals for the District of Columbia stated shortly before enactment of the NGPA, "If a decision is to be made to deregulate natural gas prices, it must be made by Congress, not by the [Commission]." [276] Accordingly, the Commission must respectfully decline to adopt DOJ's proposal.

C. *Incentive Price Proposal.*

In light of the comments submitted in this proceeding, the Commission has concluded that there are some remaining open issues with regard to the basis for the incentive

[276] *Public Service Commission of New York v. FERC*, 589 F.2d 542, 550 (D.C. Cir. 1978). *See also, FPC v. Texaco, Inc.*, 417 U.S. at 397-98.

price portion of the DOE proposal at this time. Therefore, we are still reviewing the matter and will rule on the incentive price proposal in a separate order to be issued at a later date.

D. *Transportation Authority.*

A number of commenters express the concern that pipelines may release gas under the good faith negotiation rule but then refuse to provide transportation to another purchaser. As one producer commenter puts it, "[t]he pipeline which can refuse to transport the released gas to an alternative market is in a position to extract unreasonable concessions from the producer, or even to refuse to negotiate at all." [277] To remedy this perceived deficiency in transportation availability, NGSA proposes that pipelines be allowed to transport gas released as a result of the good faith negotiation process without becoming subject to open-access transportation obligations under Order No. 436.[278] In a similar vein, Indicated Producers state that a blanket transportation certificate should be granted to non-open-access pipelines which would authorize those pipelines to transport released gas on behalf of the seller or the new buyer.[279] Certain industrial end-users suggest that in order for a producers' sections 104 and 106 gas to be eligible for the higher just and reasonable price, the producer should first be required to file an affidavit agreeing to renegotiate fully its contracts covering gas other than old gas with any interstate pipeline that accepts Order No. 436.[280] The purpose would be to entice pipelines to elect open-access transportation under Order No. 436 in exchange for the opportunity to renegotiate uneconomic contracts. In return, transportation would be assured for sections 104 and 106 gas released under the good faith negotiation process.

The Commission has considered carefully the requests for blanket transportation of gas released under the good faith renegotiation process or for transportation authority without triggering the open access requirements of Order No. 436. We conclude that this rule should establish reasonable procedures by which gas which is released pursuant to the good faith negotiation procedures can be transportated by pipelines not under Order No. 436. It is clear that for the potential benefits of this rule to be realized in terms of both supply and price response, released gas must be able to be marketed. However, without Commission action, there is no assurance that first sellers will be able to market their released gas unless their existing purchasers have accepted the terms and conditions of Order No. 436. We believe it is essential to formulate reasonable and fair transportation provisions in light of the revised good faith negotiation procedures adopted as part of this rule so as to assure the availability of transportation service irrespective of whether a particular purchaser has or has not accepted the open-access obligations of Order No. 436. Consequently, we will provide for the availability of conditional transportation services by pipelines not under Order No. 436.

As an integral part of the new ceiling price and the good faith negotiation procedure itself, the Commission is including limited authority for an existing pipeline purchaser to transport gas released under the rule. The Commission also is deeming the releasing pipeline to agree

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[277] *Texaco Inc.* at 11-12.

[278] *See* NGSA at 28. *See also, e.g.*, Indicated Producers at 68 ("to the extent pipelines do not accept open access transportation certificates [under Order No. 436], . . . the Commission must adopt a policy or negotiation process which would assist in providing transportation of released gas, whether or not Order No. 436 certificates are widely used.") Attached to this preamble as Appendix B is a list of the 34 pipelines that, as of the issuance of this rule, have filed under Order No. 436 or have otherwise announced their intention to negotiate settlements in order to file under Order No. 436.

[279] Indicated Producers at 68.

[280] *See* PGC at 4.

to transport such gas to its existing customers or any interconnecting pipeline, as a condition of the ability of the existing pipeline purchaser to terminate purchases of gas from a first seller under the rule. The purpose of this limited transportation authority is to assure that the prices of gas renegotiated under the rule are subject to the maximum benefits of competitive pressures by alternative buyers and sellers in gas markets. Without access to transportation, the renegotiation process would be insulated from these competitive benefits, and both producers and pipelines would be restricted in their access to gas supplies released under the rule. At the same time, the Commission considers the limited transportation authority as an essential element of the firm sales customers' right of first refusal to old gas released by their pipeline suppliers under the rule. For a firm sales customer, especially a full requirements customer with no access to alternative suppliers, the right of first refusal cannot be exercised in any practical way to avoid the loss of old gas off-system under the rule unless the customer has meaningful access to transportation. Under the good faith negotiation procedure, the existing pipeline purchaser may choose or not choose to terminate purchases of gas under an existing contract with a producer. As a condition on the pipeline's exercise of these options, the limited transportation authority is reasonably intended to assure that the pipeline's existing customers, especially firm sales customers, have a practical means of keeping the gas on-system and getting it transported for their use.

Under the good faith negotiation rule proposed by DOE, indefinite price escalator clauses in old gas contracts are prevented from becoming automatically operative, and pipelines are provided the opportunity to negotiate the price they are willing to pay up to the new ceiling price. In the event no price agreement is reached, the producer has the right to abandon the sale. The procedures adopted by this rule conform to DOE's proposal

in providing for producer abandonment in cases where the producer seeks to renegotiate the price of old gas but is unable to do so. This rule also modifies DOE's proposal by providing that in various circumstances purchasers may request price renegotiation of higher-priced categories of gas and may discontinue purchasing such gas in cases where no agreement on repricing is reached. The good faith negotiation procedures adopted by this rule thus extend to purchasers significant and substantial rights in addition to those incorporated in the rule as proposed by DOE. The Commission finds that it is reasonable and consistent with the objectives of this rule to make the exercise by purchasers of their rights under the good faith negotiation rule conditional upon the availability of transportation services for gas released pursuant to the rule. We have previously determined that the existing old gas price structure is inefficient or unjust and unreasonable and should be replaced by a uniform, alternative just and reasonable ceiling price equal to the post-1974 price. In most instances, first sellers would be unable to market released gas to alternative purchasers unless the existing purchaser agreed to transport the gas or is an Order No. 436 transporter. The existing purchaser would have little or no incentive to do so, however, because in the absence of transportation the first seller would have little alternative but to continue selling to the existing purchaser at the current price. The result would frustrate the purposes of this rule and force the first seller to accept a price which we have found to deny both consumers and producers the full benefits of competition and long-term reliable gas service under the NGPA and NGA. We therefore believe that the good faith negotiation procedures would be ineffective to accomplish the goals of this rulemaking unless combined with a transportation provision designed to encourage purchasers to negotiate in good faith and to provide first sellers with reasonable access to an alternative market in the event no agreement on pricing is reached.

Consequently, the Commission is providing for conditional transportation services under its NGPA authority to condition the new ceiling price under sections 104(b)(2) and 106(c), as well as under its NGA authority to determine that the existing ceiling price structure for old gas is in need of revision or otherwise unjust and unreasonable pursuant to section 5(a) of the NGA. The Commission need not specifically find that the failure to condition the new ceiling price with a transportation provision would cause the new ceiling price to be unjust and unreasonable under section 5(a) of the NGA. However, the Commission is so finding here, because it considers access to transportation for gas released under this rule to be essential for the protection of consumers and the achievement of market-responsive gas prices intended by the final rule.

We have previously determined that firm sales customers of the existing purchaser should have a right of first refusal enabling them to match any third-party offer to purchase gas released pursuant to this rule. We believe that in cases where firm sales customers exercise their right of first refusal and thereby agree to purchase released gas, the existing purchaser should be deemed to have agreed to transport that gas to the purchasing firm sales customer. Our reasons for this determination are the same as those underlying our decision to grant firm sales customers the right of first refusal as to gas abandoned under this rule. We will also provide that an existing pipeline purchaser shall transport abandoned gas to any of its customers and any interconnecting interstate, intrastate, or Hinshaw pipelines [281] on behalf of any person who purchases abandoned gas. Our decision to include this additional conditional transportation service is designed to provide the releasing pipeline's customers and interconnected pipelines and their customers access to gas released pursuant to this rule. In addition,

[281] *See* NGA section 1(c); 15 U.S.C. § 717(c) (1982).

we seek to provide first sellers with reasonable access to transportation service. We believe that providing for transportation of released gas to customers of the transporting pipeline and to interconnecting pipelines, regardless of who purchases the released gas, will provide first sellers with sufficient access to alternative markets to insure that the purposes and objectives of this rule will be realized. This additional sales market will assure that wellhead markets remain workably competitive, that producers have access to a substantial market as an alternative to continuing sales to the existing purchaser, and that firm sales customers of the releasing pipeline interested in exercising their right of first refusal can obtain the benefits of these competitive forces.

We will therefore consider that in cases where any gas is released from a particular contract under the good faith negotiation procedures, the former pipeline purchaser is deemed to agree to transport the released gas to any of its customers who purchase such gas or to any pipeline with which it is interconnected, upon 30-days written notice from the first seller to the transporting pipeline. The transportation provision, to which releasing pipelines are deemed to have agreed to perform under the good faith negotiation procedures, attaches to the released gas and is not provided for the benefit of any particular purchaser. Therefore, transportation of the released gas through the releasing pipeline on behalf of any purchaser requesting such transportation will continue until the supply is exhausted, or authorization for transportation of such gas ceases upon the expiration of a contract where a pipeline subsequently becomes subject to Order No. 436. In order that the transportation of released gas can be commenced without unnecessary delay or regulatory cost to the pipeline, the Commission will grant a blanket transportation certificate under section 7(c) of NGA to jurisdictional natural gas pipelines not already transporting under Order No. 436. Transportation under the blanket certificate shall be provided as far

as practicable in accordance with the terms and conditions requested by the first seller and its purchaser. The rate to be charged shall conform to the requirements of new section 284.225(d) of the Commission's regulations promulgated as a part of this rule. In order to permit existing firm sales customers to obtain full and immediate access to gas released under the rule and subject to the right of first refusal, such customers will be able to obtain transportation of such gas within their existing firm sales contract demand without incurring costs beyond what they would have incurred in purchasing the gas from the releasing pipeline.

Pipelines transporting gas under the blanket certificate shall not become subject to the open-access requirements of Order No. 436 (18 C.F.R. §§ 284.8(b) and 284.9(b) by reason of such transportation. Any pipeline which is not subject to the open-access requirements of Order No. 436 and which is requested by the first seller to provide transportation service may apply for a separate transportation certificate under section 7(c) of the NGA. The Commission finds that any refusal by a pipeline to transport gas abandoned under the good faith negotiation procedure would constitute an unduly discriminatory or preferential practice violating section 5(a) of the Natural Gas Act because the refusal could be used by a pipeline as a "bargaining chip" or tying arrangement in establishing a renegotiated price under an existing contract for the sale of old gas under the final rule. The Commission also considers that such a refusal to transport could constitute a violation of antitrust law if it amounts to an effort by a pipeline to extend its regulated monopoly power over access to transportation services to wellhead gas markets that are workably competitive under the mandate of the NGPA. The Commission will carefully scrutinize any such refusals to transport or tying arrangements and intends to fully enforce its obligation under the Natural Gas Act and other law.

E. Blanket Sales Certificates.

Tennessee Gas Pipeline Company asserts that the proposed rule is flawed because it lacks any requirement that a producer first obtain a certificate of public convenience and necessity prior to any new sale for resale in interstate commerce of gas abandoned as a result of the good faith negotiation process.[282] In response to this concern and in order to effectuate the contract renegotiation and market-responsive pricing objectives of the good faith negotiation procedure, the Commission is incorporating a blanket certification authorization into the rule, with a concomitant pre-granted abandonment authorization. These authorizations will permit a producer to sell gas abandoned as a result of the good faith negotiation rule to a new purchaser and to abandon the sale at the end of the contract.

The Commission finds that such blanket sales certificates with pre-granted abandonment are permitted by the public convenience and necessity. Without a blanket certificate, producers would have to file an application for a certificate (filing fee $2,800 for a large producer) for each jurisdictional sale they proposed to make. This would be costly to producers, administratively burdensome, and hinder smooth implementation of this rule. Regulatory delay in obtaining required certificates and abandonment authority tends to place jurisdictional customers at a competitive disadvantage vis-a-vis non-jurisdictional entities not affected by such requirements. As a result, the relatively low-cost gas made available by the operation of the rule would not be as readily available to many LDC's and their customers as it would be to intrastate customers. Congress intended through enactment of the NGPA to establish equality of marketing opportunities as between the interstate and intrastate

[282] *Tennessee Gas Pipeline Company* at 9.

markets.[283] Accordingly, the public convenience and necessity is served by granting blanket certificate and abandonment authorization.

This action is comparable to the Commission's recent orders in *Pennzoil Producing Company and Pennzoil Gas Marketing Company*, Docket Nos. C186-54-000 and C186-57-000, 34 FERC ¶ 61,318 (1986). Pre-granted certificate and abandonment authorization are also fully consistent with the overall objectives of this rule. By allowing old gas to be marketed to the jurisdictional market without unnecessary regulatory delay, the blanket procedure promotes the supply and price benefits of the rule in both the interstate and intrastate markets.

The NGPA with its phased system of deregulation (section 121) and its limitations on the Commission's Natural Gas Act jurisdiction (section 601), was crafted to lessen the disparities in regulation of interstate and intrastate gas, thereby facilitating a national market based on freer competition. Where the Commission's NGA jurisdiction remains, common sense dictates regulatory policies (such as the traditional case-by-case certification processes) that were grounded in a pre-NGPA era should be pragmatically updated. Congressional purposes are furthered by adapting our certificate procedures to the evolving national competitive environment that was the goal of Congress in enacting the NGPA. Making the Commission's certification function more flexible is legally compatible with the freer competitive market intended by the NGPA, even for those portions of the industry that remain regulated by the Commission. The Commission has adopted the same rationale in eliminating other regulatory vestiges of the pre-NGPA gas industry era. For example, in eliminating pipeline minimum take provisions the Commission observed: [284]

> As the Commission stated in *City of Florence, Alabama v. Tennessee Gas Pipeline Co.*, 24 FERC ¶ 61,395, at 61,839 (1983), competition can and should play an important role even in a regulated industry such as the natural gas industry. "If competition exists, incentives are created for innovation by the regulated companies. This, in turn, encourages lower prices and better service." This is precisely what the Commission is attempting to do by adapting our regulations to respond to evolving competitive forces.

It is reasonable to make certificate procedures more flexible to serve the purposes of this rule. In doing so, the Commission is simply adapting its regulations to respond to evolving industry and market conditions. Given the competitive environment of today's natural gas market, blanket sales certificates will encourage lower prices and better service nationwide.

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[283] Congress intended the NGPA to end the anomaly of ample supplies in the intrastate market and the recurring, severe shortages in the interstate market that existed during the Seventies. The NGPA's pricing scheme was intended to increase the supply of gas reserves and production and to decrease distorted consumption demand at the end-use level. The Commission's intention in this rulemaking is to serve those ends. The provision of blanket sales certificates is intended to maintain the uniformity of national market opportunities intended by the Act. *See*, H.R. Rep. 496, pt. IV, 95th Cong. 1st Sess. 101 (1977); Congressional Budget Office, The Natural Gas Compromise Report 2 (1978), *reprinted in* 124 Cong. Rec. H13126-27 (daily ed. Oct. 4, 1978) The Commission in implementing other provisions of the NGPA has similarly responded to the need to keep opportunities in jurisdictional and non-jurisdictional markets equal. *See e.g.* Order No. 108-A 48 FR 48223 (Oct. 18, 1983) ("This order on rehearing affords [intrastate] sellers of gas . . . the same opportunity to collect an allowance for State severance taxes under section 110(a)(1) as the Commission has afforded sellers of interstate gas.")

[284] Order No. 380-C, 49 FR at 43626 (Oct. 31, 1984), *aff'd, Wisconsin Gas Co. v. F.E.R.C.*, 770 F.2d 1144 (D.C. Cir. 1985), *cert. denied*, 54 U.S.L.W. 3761 (U.S., May 19, 1986) (No. 85-1219).

F. *Response to Administrative Law and Procedural Claims*

During this proceeding, the Commission received a variety of pleadings that pose procedural requests and objections. Motions, petitions, applications, and answers have no special procedural significance in informal rulemakings, and the Commission therefore disposes of these pleadings here as it would other comments. Elsewhere in this order, the Commission addresses the important substantive issues underlying these pleadings. It therefore makes clear at this point only the results of its review of other issues presented, as follows.

1. Associated Gas Distributors (AGD) filed on January 17, 1986, a petition requesting additional discovery and comment procedures. The petition, submitted early in the Commission's 60-day initial comment period,[285] outlined a variety of formal procedures designed allegedly to facilitate information gathering by the commenters and the Commission, including the submission of interrogatories to the Secretary of Energy for his response,[286] discovery among participants in the proceeding pursuant to special Commission procedures, additional time to accommodate "this more rigorous informational process," and an opportunity to file comments in reply. AGD supplied the Commission with a memorandum of law empahsizing the factual nature of any decision that would implement the DOE proposal in this proceeding.[287]

[285] On February 19, 1985, AGD requested 30 additional days to file initial comments. The Commission allowed reply comments instead.

[286] AGD requested such procedures under the general and discretionary provisions of Section 403(d) of the Department of Energy Organization Act (DOE Act), 42 U.S.C. § 7173(d) (1982).

[287] The AGD memorandum alleges that the DOE failed to provide adequate notice of the information underlying its proposal, in violation of Section 501(b)(1) of the DOE Act, 42 U.S.C. § 7191 (b)(1) (1982). The Commission does not believe that Section

United Distribution Companies (UDC) filed in support of the AGD petition. DOE also answered the AGD petition, committing itself to providing additional analytical support for the rule.

The Commission recognizes AGD's concern that an action to raise the maximum lawful price of old gas, subject to the good faith renegotiation of existing contracts, must be the product of thorough investigation and a reasoned analysis of substantial evidence in the record. The Commission nevertheless firmly believes that it has developed a sound and comprehensive record, without the unnecessary formality and procedural complexity requested by AGD. As requested, the Commission provided an opportunity for submittal of reply comments by any interested persons. The reply comments tested the soundness of the data and arguments submitted in initial comments. The Commission provided for yet another opportunity to present data and views when it held two days of public hearings on the rule. All segments of the gas industry, the public, and state regulators participated.

501(b)(1) is applicable to this proceeding. To the extent that it may apply, however, the Commission finds no deficiency in the DOE proposal, which fully apprised the public of the legislative facts and policies relied on by the Secretary. For any rulemaking, such as this one, governed by the notice requirements of the Administrative Procedure Act, the DOE proposal contains far in excess of the minimum of necessory information. It is both unusual and unnecessary for a notice of proposed rulemaking to exhibit the same quantum of data that is normally developed by the participants in the proceeding and utilized by the agency for a final rule. Comment procedures are not mere formalities that led to foregone conclusions.

AGD also filed with DOE a Freedom of Information Act request for all cost and other factual data relating to its proposed rule. DOE subsequently filed in this proceeding the data that it provided in response to that request.

The Commission's December 20, 1985 notice of procedural schedule also expressly requested commenters to include quantitative and qualitative data in their comments, and the record in this proceeding includes numerous responses to this request.

Most participants presented written and oral testimony in response to the initial and reply comments, including additional analytical material for the record. As a consequence of these thorough information-gathering procedures, the record contains a lively debate of the issues and full analyses of the data presented to the Commission. DOE, as well as other commenters, supplied the Commission with extensive quantitative and qualitative studies and analyses discussed throughout this order. In light of the extensive public procedures, the issues in this rulemaking have been fully ventilated and the evidentiary record is complete.

2. On February 10, 1986, UDC filed a petition and supporting memorandum requesting immediate and summary dismissal of the DOE proposal on grounds that the Secretary "would have the Commission embark upon a rulemaking that completely contravenes established bounds of the Commission's authority . . . [under] the Natural Gas Act and Natural Gas Policy Act." Although UDC characterizes its complaint as involving jurisdictional issues, the pleading in fact pertains to whether the Commission has sufficient information and authority to implement the DOE proposal and could do so in a reasoned manner. As this order demonstrates, the Commission does not concede UDC's allegations that its authority is so severely restricted that it is foreclosed from even considering the issues presented by DOE. In any event, the rulemaking process is designed to afford a fair and open examination of such issues by affected parties; summary dismissal would be inappropriate for such proceedings.

3. On May 12, 1986, the American Gas Association (AGA) petitioned the Commission for additional procedures similar to those requested earlier by AGD to permit further development of the record in this proceeding.[288]

[288] Answers to AGA's petition were filed by the Indicated Producers, Northern Illinois Gas Company, Office of the Consumers' Counsel, State of Ohio, and Southern California Gas Company.

AGA requests that the Secretary be required to respond to written questions and that discovery among all participants to this rulemaking be sanctioned by the Commission. Based on its review of the entire record, AGA alleges various evidentiary deficiencies that it contends renders the Commission incapable of taking legally defensible actions on core issues.

The Commission recognizes that factual disputes and policy disagreements exist in the record. It is convinced that by providing for initial and reply comments and a public conference, the Commission has fulfilled its statutory obligations under applicable rulemaking procedures.[289] These procedures have also met the goals of the AGA and other commenters who seek and deserve a critical and thorough examination of the views and information related to the repricing of old gas supplies. Rulemaking proceedings need not resolve all disputes of fact on such subjects. It is enough that a decisionmaker afford an ample and equal opportunity to participate and, if it believes that the evidence is adequate, make its decision in a reasoned manner. The addition or repetition of information-gathering procedures does not necessarily ensure a better or more complete record, in terms of the quality of the data submitted or how well the participants or the decisionmaker use the information. The Secretary's deadline for final Commission action notwithstanding, this rulemaking has not been attenuated. The Commission therefore concludes that it has in this record sufficient information upon which to decide the key issues to which the AGA points. It therefore declines to delay further its consideration of final action based on that record.

[289] *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1167-68 (D.C. Cir. 1985), *cert denied*, 54 U.S.L.W. 3761 (U.S., May 19, 1986) (No. 85-1219) (*citing Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978) and *American Public Gas Association v. FPC*, 567 F.2d 1016 (D.C. Cir. 1977).

4. On May 23, 1986, the American Gas Association, Associated Gas Distributors, the Interstate Natural Gas Association of America, and United Distribution Companies filed a joint petition requesting the Commission to delay the effective date of this rule for 120 days after the issuance of an order on rehearing. The petitioners argue that unless the effective date is deferred, permanent and irreversible actions may be taken by the parties before there is an opportunity to test the legal merits of the order. Petitioners are concerned that reserves may be lost if producers abandon sales under the good faith negotiation provision or that markets may be lost if pipelines must pay higher prices for old gas.

The Commission believes that this final rule will provide price and supply stability to the gas markets, and that the parties represented by petitioners will not be disadvantaged as they allege. However, the Commission separately hac concluded for other reasons discussed below, that implementation of the renegotiation provision should be delayed.

The Commission independently recognizes that the order will affect thousands of gas purchase contracts. The changes to the marketing of natural gas established by the rule are complex. Because of the importance of the rule for the gas industry, the Commission has concluded that more time than proposed by DOE may be needed by the parties to the contracts to determine if, when, and under what terms to renegotiate. Delaying implementation of the good faith negotiation provision until the fall would allow the parties time to examine the economic consequences of the final rule and engage in voluntary renegotiation of their contracts outside of the good faith negotiation procedures.

While the Commission agrees with the petitioners that the portion of the rule requiring renegotiation should be delayed, it does not agree that it should be delayed 120 days from the order on rehearing. The Commission at

this time is unable to determine when an order on rehearing may be issued and is reluctant to delay the implementation of any portion of the rule other than to a date certain. Such an unwarranted delay would unjustifiably delay the market-responsive pricing and supply benefits to consumers intended by the final rule. Therefore, the Commission is delaying the effectiveness of the renegotiation provision of the rule until November 1, 1986.

VII. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) [290] generally requires a description and analysis of final rules that will have a significant economic impact on a substantial number of small entities.[291] Specifically, if an agency promulgates a final rule under the Administrative Procedure Act (APA),[292] a final RFA analysis may be appropriate. A final RFA analysis must contain (1) a statement of the need for and objectives of the rule, (2) a summary of the issues raised by the public comments in response to any initial regulatory flexibility analysis, and the agency response to those comments, and (3) a description of significant alternatives to the rule consistent with the stated objectives of the applicable statute that the agency considered and ultimately rejected. An agency is not required to make an RFA analysis, however, if it certifies that a rule will not have "a significant economic impact on a substantial number of small entities." [293]

As discussed, the Commission believes it must revise its regulation of old, flowing gas prices under the authority of the NGPA sections 104 and 106 because its regulation has created and continues to promote a wide disparity between wellhead prices for natural gas. In particular,

[290] 5 U.S.C. 601-612 (1982).

[291] *Id.* 604(a).

[292] *Id.* 553.

[293] *Id.* 605(b).

the Commission's past regulation fostered prices of old, flowing gas that are unresponsive to changes in wellhead markets, fail to assure that city-gate prices reflect the cost of replacing depleted gas reserves, directly contribute to the "boom and bust" tendency of investment in the gas industry, and inhibit consumers from receiving the full benefits of wellhead competition as Congress intended by enacting the NGPA.

As permitted by the RFA, the Commission certified that the rule proposed by the Secretary of Energy, if promulgated, would not have a significant economic impact on a substantial number of small entities. The Commission concluded that the proposed rule would have a positive impact on the small entities subject to the rule. By raising the maximum lawful price of gas regulated under NGPA sections 104, 106 and 109, the DOE proposal would have enabled small producers that sell old flowing gas to improve their revenues and enhance their ability to sell that gas. Since the RFA requires the Commission to analyze only the impacts on small entities that will be subject to the rule,[294] the Commission concluded that the economic impact of the proposed rule would not be "significant" within the meaning of the RFA, since the impact on these small entities was expected to be beneficial.

Generally, this rule adopts the DOE proposal with modifications, especially to the "good faith negotiation" rule. Specifically, the Commission provides that each pipeline-purchaser has the right, similar to the producer's right, to request a producer to nominate new prices for the producer's gas, if the producer has requested the pipeline to nominate higher prices for old gas which the producer believes is being sold at below-market prices. In other words, the pipeline is entitled to request a new price for

[294] *Mid-Tex Electric Cooperative Inc. v. FERC.*, 773 F.2d 327, 340-43 (D.C. Cir. 1985).

the producer's old gas and any other gas sold under any contract containing old gas, if the producer requests the pipeline to nominate a price for old gas. In this way, the producer has the option to seek higher prices for its old gas, but that producer must be ready to renegotiate the price of any gas sold under any contract that contains old gas, if it exercises this option. The Commission believes that this modification provides producers and pipelines balanced negotiating positions, but protects small producers by permitting each producer to decide whether it is to its benefit to seek higher prices for its old gas.

Several commenters disagree with the Commission's certification that the proposal would not, if adopted, cause "a significant economic impact on a substantial number of small entities" wthin the meaning of the RFA. They contend that the Commission's certification under the RFA is flawed because the Commission considered only an unspecified number of the Nation's approximately 10,000 natural gas producers as small entities and mistakenly predicted that a beneficial economic impact on these small entities will result from the implementation of the proposed rule.

In particular, Northern Indiana Public Service Company (NIPSCO) asserts that the Commission improperly restricted its consideration under the RFA to natural gas producers. NIPSCO maintains that the definition of small entities includes small businesses as defined under section 3 of the Small Business Act, small non-profit organizations and small governmental jurisdictions such as cities and towns with populations of less than 50,000 persons. NIPSCO believes that far more such small entities than simply natural gas producers will suffer significant economic impacts from higher old gas prices. In addition, AGA argues that the Commission's certification ignores the economic impacts of the proposal on such small entities as small distributors and other small gas purchasers, which account for millions of jobs and could be deva-

stated by an increase in the price their pipeline suppliers would be required to pay for old gas under the proposed rule.

AGA also asserts that a large number of small producers will be financially injured if lower prices for high-cost gas result from the proposal. If new gas prices do not fall as much as old gas prices rise under the proposal, however, a large number of small gas distributors and their customers will also be financially injured, maintains AGA. Similarly, the Texas Independent Producers and Royalty Owners Association (TIPRO) expresses concern for its membership whose high-cost contracts could be renegotiated downward under the proposal. TIPRO believes that "tens of thousands" of small entities will be adversely affected without receiving a corresponding benefit in exchange.

The Commission believes that these commenters misunderstand the intent of the RFA. As NIPSCO notes, the definition of small entity includes small businesses as defined under section 3 of the Small Business Act, small non-profit organizations and small governmental jurisdictions. So, the Commission need not analyze the effect on large producers in deciding whether there will be a significant impact within the meaning of the RFA. In addition, the Commission does not consider the effect on pipeline purchasers when it certifies no impact because most jurisdictional natural gas pipelines do not fall with the RFA's definition of small entity; they are (1) too large to be considered "small entities", or (2) holders of exclusive selling rights within a respective field of operation and are therefore dominant in that field of operation. Similarly, commenters' arguments that the Commission must consider the effects of this rule on small end-users, royalty interest owners, and every small producer selling gas in the United States overstates the proper application of the RFA. In particular, Congress was not asking agencies to study any potential economic

effect on any small entity even if only indirectly affected by the rule. As noted in previous proceedings,[295] this Commission, like other agencies,[296] is required by the RFA to analyze only the effect of rules on regulated small entities to which the requirements of the rule apply.[297] Congress was clear about the reach of the statute: when an agency issues a rule that applies to small entities, the agency must consider, and try to mitigate, the burden on those small entities of compliance with the rule.[298] The legislative history also echoes a concern about burdensome reporting and compliance requirements.[299]

Although Commission regulation affects in some way all small end-users, small royalty owners, and small producers, neither small end-users, small royalty owners, nor small producers that do not sell NGPA section 104 or 106 gas are subject to the requirements of this rule. In particular, the Commission believes that, because of increased volumes of relatively inexpensive old gas on the market,

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[295] Construction Work in Progress for Public Utilities; Inclusion of Costs in Rate Base, 48 Fed. Reg. 24,323 (June 1, 1983) (Docket No. RM81-38-000) (Order No. 298 *rehearing granted in part and denied in part*, 48 FR 46012 (Oct. 11, 1983); Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, 49 FR 22778 (June 1, 1984) (Docket No. RM83-71-000) (Order No. 380), *order on rehearing*, 49 FR 31,259 (Aug. 6, 1984).

[296] *See, e.g.*, 47 FR 5215 (Feb. 4, 1982) (final rule of Securities and Exchange Commission).

[297] *Mid-Tex Electric Cooperative Inc. v. FERC*, 773 F.2d at 342 (No RFA analysis is necessary when the agency determines that the rule will not have a significant economic impact on a substantial number of small entities that are subject to the requirements of the rule).

[298] *See* Congressional Findings and Declaration of Purpose, section 2, Pub. L. No. 96-354, codified at 5 U.S.C. 601, note (1982).

[299] For a discussion of the legislative history, *see* Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, *supra*, 49 FR at 22791.

many producers that sell high-cost gas not subject to NGPA section 104 or 106, including some small producers, may not be able to continue to collect the current above-market price for gas that may be allowed under existing contracts. This is an intended effect of this rule. However, these small producers are not subject to the requirements of this rule and, therefore, the RFA does not require separate analysis of the effects on them when the Commission decides whether an RFA certification is appropriate. Of course, the response of the gas markets, including these high-cost gas contracts, to the renegotiation upward of low old gas costs is a primary focus of this rulemaking.

Direct effects of the rule on small producers is as follows. As explained earlier, this rule would raise the maximum lawful prices for NGPA sections 104 and 106 gas for (1) all new contracts executed after July 18, 1986, and (2) contracts with indefinite price escalator clauses in effect on July 18, 1986, if the producer elects to seek a higher price for some or all of its NGPA sections 104 and 106 gas. The Commission believes that the effect on small producers that have NGPA sections 104 and 106 gas reserves to sell will primarily be beneficial for the following reasons, as well as the reasons cited in this preamble generally, *supra*.

The rule requires a small producer to decide whether to seek a higher price for some or all of its old gas. If the producer does not seek a higher price for its gas, the rule has no effect on the price or service obligation imposed on that small producer under its existing contracts. In this way, if a small producer has contracts for old gas at prices above the market-price, that producer may continue to sell under these contracts without being subject to this rule.

In contrast, if the small producer requests a pipeline to nominate a higher price for some or all of its old gas, a pipeline may request that the producer nominate a

price for any old gas and any other gas sold under any contract containing old gas.[300] If the pipeline does not nominate the highest price provided by an existing contract or a price agreeable to the small producer for some of the producer's gas, the small producer is granted automatic abandonment, sales authority and the transportation by the original pipeline-purchaser necessary to market that gas if the producer finds a new purchaser. Similarly, if the pipeline refuses to accept the price nominated by the small producer for some of the producer's gas, the pipeline may terminate its purchases of that gas and the small producer is granted automatic abandonment, sales authority and the transportation by the original pipeline-purchaser necessary to market that gas if a small producer finds a new purchaser.

In essence, this rule protects small producers in two major ways. First, the rule permits a small producer to decide whether to participate in the good faith negotiation procedures for existing contracts. Second, the rule provides small producers that participate in the good faith negotiation procedures with abandonment, sales, and transportation authority to market its gas if the small producer and pipeline are unable to agree on a suitable price for some or all of the producer's gas.

The Commission chose this procedure in order to minimize or eliminate any adverse effects on small entities. It could have adopted an alternative of deeming that every contract for sale of NGPA sections 104 and 106 gas to have a "market-out clause" that would permit either the purchaser or the seller to terminate the contract upon notice, if the price is unsuitably above or below a particular established price. But this approach could cause unintended harms and hardships on small producers. Similary, the Commission could have adopted an alterna-

[300] The Commission notes that small producers have been exempt since 1971 from many of the Commission's rate and certificate filing requirements. 18 C.F.R. 157.40 (1985).

tive of not raising the maximum lawful price for NGPA sections 104 and 106 gas. The Commission decided that new MLP's were necessary to eliminate the distortions caused by Commission regulation, but determined that permitting producers to decide whether to seek higher prices for their gas would prevent unintended harms and hardships, particularly to small producers. By providing producers the option to renegotiate for a higher price for old gas, the Commission permits a small producer to choose the course of action that is most beneficial to that small producer.

For all these reasons, the Commission believes that this rule would be beneficial to small producers by raising the maximum lawful prices for NGPA sections 104 and 106 gas, increasing the ability of small producers to sell their gas, and increasing the price paid to small producers for NGPA sections 104 and 106 gas, without requiring any small producer to modify or change any contract for NGPA sections 104 and 106 gas. Since the impact on the small entities regulated by this rule is expected to be beneficial, the Commission does not believe that the economic impact will be "significant" within the meaning of the RFA. Pursuant to section 605(b), the Commission accordingly certifies that this rule will not have a "significant economic impact on a substantial number of small entities."

VIII. Effective Date and Paperwork Reduction Act Statement

1. The rule becomes effective July 18, 1986; however no producer may make a nomination request under the good faith negotiation rule before November 1, 1986.

2. In general, the Commission is relying on existing reporting requirements and information collection provisions to implement the rules adopted in this proceeding. For example, producers that amend an existing contract must continue to file rate schedules under section 4 of

the Natural Gas Act and § 154.92 (requiring independent producers to maintain rate schedules on file with the Commission); and 154.94 (requiring rate schedule filings with the Commission before a change in rate is effective) of the Commission's regulations. In addition, the limited exemption from filing requirements applicable to small producers under § 157.40 of the Commission's regulations remains applicable. In contrast, the Commission does establish a new filing requirement for producers that are granted certificates of public convenience and necessity to sell gas for resale in interstate commerce under new § 157.301 of the Commission's regulations. Under this filing requirement, producers must file an annual report with respect to any sales under that certificate initiated during the previous calendar year. The producer is only required to report each sales arrangement once. This report would detail, among other information: (1) The new and former purchaser and the terms of sale of gas sold under the blanket certificate authority of new § 157.301; and (2) the total estimated annual sales volumes of gas sold under the blanket certificate authority of that section. In addition, the rate filing requirements of §§ 154.92 and 154.94 of the Commission's regulations are waived for sales under a certificate granted under new § 157.301 of the Commission's regulations.

The information collection provisions in this rule are being submitted to the Office of Management and Budget (OMB) for its approval under the Paperwork Reduction Act [301] and OMB's implementing regulations.[302] Interested persons can obtain information on these information collection provisions by contacting the Federal Energy Regulatory Commission, 825 North Capitol Street, NE., Washington, DC 20426 (Attention: Ellen Brown (202) 357-8272). Comments on the information collection provisions can be sent to the Office of Informa-

[301] 44 U.S.C. 3501-3520 (1982).

[302] 5 CFR 1320 (1986).

tion and Regulatory Affairs of OMB, New Executive Office Building, Washington, DC 20503 (Attention: Desk Officer of the Federal Energy Regulatory Commission).
List of Subjects:

18 C F R Part 154

Alaska, Natural gas, Pipelines, Reporting and recordkeeping requirements.

18 C F R Part 157

Administrative practice and procedure, Natural gas, Reporting and recordkeeping requirements.

18 C F R Part 270

Natural gas, Price controls, Reporting and recordkeeping requirements.

18 C F R Part 271

Continental shelf, Natural gas, Price controls, Reporting and recordkeeping requirements.

18 C F R Part 284

Continental shelf, Natural gas, Reporting and recordkeeping requirements.

In consideration of the foregoing, the Commission is amending Part 154, 157, 270, 271 and 284. Title 18, Code of Federal Regulations, as set forth below.

By the Commission.

KENNETH F. PLUMB,
Secretary.

APPENDIX A

COMMENTS FILED IN DOCKET NO. RM86-3-000

Note.—The following appendix will not appear in the Code of Federal Regulations.

City of Albion, Nebraska
City of Alliance, Nebraska

*† American Gas Association
American Farm Bureau Federation
* American Paper Institute, Inc.
*† American Public Gas Association
*† Amoco Production Company
ANR Pipeline Company
Applied Resources International, Inc.
*† ARCO Oil and Gas Company
Arkansas Public Services Commission
*† Associated Gas Distributors
Association of Texas Intrastate Natural Gas Pipelines
Baltimore Gas and Electric Company
Bass Enterprises Production Company
† California Public Utilities Commission
City of Chadron, Nebraska
† Chemical Manufacturers Association
Chevron U.S.A.
*† Cities Services Oil and Gas Corporation
† Citizen/Labor Energy Coalition
Citizens Energy Corporation
City Gas Company, et al.
Columbia Gas Distribution Companies
† Columbia Gas Transmission Corporation
Consolidated Edison Company of New York, Inc.
Consumer Advocate Division of Public Service
 Commission of West Virginia
Consumers Power Company and Michigan Gas Storage
 Company
James L. Coosby, The Hobby House
Council of Energy Resource Tribes

Council of Industrial Boiler Owners
City of Cozad, Nebraska
Davis Gas Processing, Inc.
* Delhi Gas Pipeline Corporation
Donaldson, Lufkin & Jenrette
Dorchester Hugoton Ltd.
*† E.I. Dupont de Nemours and Company
El Paso Natural Gas Company
Elizabethtown Gas Company
*† Department of Energy
Hon. James Exon, and Hon. Edward Zonrinsky
*† Exxon Corporation
† Fertilizer Institute
*† Florida Cities
Florida Gas Transmission Company
City of Gering, Nebraska
Hastings Utilities
Hecks Discount Stores
City of Henderson
Hewit & Dougherty and Dougherty Properties
City of Holdredge, Nebraska
Illinois Commerce Commission
City of Imperial, Nebraska
Independent Petroleum Association of Mountain States
Indiana Manufacturers Association, Inc.
*† Indicated Producers
†* Interstate Natural Gas Association of America
Interstate Oil Compact Commission
Interstate Power Company
Iowa Gas Company
† Iowa State Commerce Commission
Jicarilla Apache Tribe
† Department of Justice
Kaneb Operating Company, Ltd.
Kansas Power & Light Company
Hon. Nancy Landon Kassebaum
City of Kimball, Nebraska
† KN Energy Inc.

Laclede Gas Company
City of Lexington, Nebraska
† Hon. Jim Ross Lightfoot
Lone Star Gas Company
† State of Louisiana
Louisiana Association of Business and Industry
Louisiana Chemical Association
*† Maryland Peoples Counsel and National Association of State Utility Consumer Advocates
* Memphis Light Gas and Water Division of City of Memphis, Tennessee
MESA Petroleum Company
* State of Michigan and Michigan Public Service Commission
* Michigan Consolidated Gas Company
Michigan Manufacturers Association
Mid Continent Oil and Gas Association
Midwest Energy Inc.
Minnesota Department of Public Service
* Minnesota Department of Public Utilities, Energy Issues Intervention Office
Mississippi Manufacturers Association
Missouri Public Service Commission
† Mobil Oil Corporation
Montana Petroleum Association
* Montana Public Service Commission
National Association of Manufacturers
National Association of Wheat Growers
National Cattlemen's Association
National Council of State Garden Clubs, Inc.
National Fuel Gas Distribution Corporation
National Grange
*† Natural Gas Pipeline Company of America
*† Natural Gas Supply Association
New England Conference of Public Utilities Commissioners, Inc.
State of New Mexico
City of New York Housing Authority

† Northern Distributor Group
† Northern Illinois Gas Company
Northern Indiana Public Service Company
*† Northern Natural Gas Company
† Northwest Central Pipeline Corporation and the William Companies
Northwest Pipeline
City of Ogallala, Nebraska
State of Ohio, Office of Consumer Counsel
Ohio Farm Bureau Federation, Inc.
Oklahoma Corporation Commission
Oklahoma Kansas Division, Mid-Continent Oil and Gas Association
Hon. Michael G. Oxley, Hon. William E. Dannemeyer, Hon. Dan Schaeffer, Hon. Bob Whittaker, Hon. Jack Fields, and Hon. James T. Broyhill
Pacific Gas and Electric Company
* Panhandle Eastern Pipe Line Company
Pennsylvania Office of Consumer Advocate
Pennzoil Company and Pennzoil Producing Company
*† Peoples Gas Light & Coke Company and North Shore Gas Company
Peoples Gas System Inc.
Petrochemical Energy Group
Piedmont Natural Gas Company, Inc.
† Plains Petroleum Company
Pogo Producing Company
James D. Price, Mississippi House of Representatives
*† Process Gas Consumers Group and Industrial Group and American Iron and Steel Institute
Public Service Commission of Commonwealth of Kentucky
† Public Service Commission of District of Columbia
*† Public Service Commission of New York
Public Service Commission of West Virginia
Public Service Company of Colorado
Public Service Electric and Gas Company
Public Utilities Commission of Ohio

* Public Utilities Commission of Rhode Island
† Questar Corporation
* Rochester Gas and Electric Corporation
San Diego Gas and Electric Company
City of Scottsboro, Nebraska
† Shell Offshore, Inc. and Shell Western E & P Inc.
Ronald C. Shows, Mississippi State Senate
City of Sidney, Nebraska
South Dakota Public Utilities Commission
Southern California Edison Company
*† Southern California Gas Company
* Southern Natural Gas Company
Southern States Cooperative Inc.
Southwest Gas Corporation
Southwest Regional Energy Council
Sun Exploration and Production Company
† Taylor Energy Company
*† Tennessee Gas Pipeline Company
Tenngasco Corporation
† Texaco Inc.
* Texas Eastern Transmission Corporation
* Texas Gas Transmission Corporation
Texas Independent Producers and Royalty Owners Association
Texas Intrastate Natural Gas Pipelines
Texas Railroad Commission
*† Transcontinental Gas Pipe Line Corporation
* Transwestern Pipeline Company and Florida Gas Transmission Company
Union Texas Petroleum
*† United Distribution Companies
Virginia Agribusiness Council
William D. Watson, Esq., Holmes Roberts & Owen
West Texas Gas Inc.
West Virginia Highway Users Conference
West Virginia Manufacturers Association
Western Gas Interstate Company
† Governor Mark White of Texas

Williston Basin Interstate Pipeline Company
Wisconsin Public Service Commission
Wisconsin-Southern Gas Company Inc.
Wyoming Public Service Commission

* Submitted reply comments.

† Participated in public conference.

APPENDIX B

FILINGS SUBMITTED FOR ORDER NO. 436 BLANKET CERTIFICATES

Note.—The following appendix will not appear in the Code of Federal Regulations.

Company name	Docket No.	Date filed	Order issued
1. Valley Gas Transmission, Inc.	CP86-171	11/1/85	11/29/85.
2. Gas Gathering Corp.	CP86-129	11/1/85	12/5/85.
3. Mid Louisiana Co.	CP86-214	11/26/85	2/11/86.
4. Columbia Gulf Transmission Co.*	CP86-239	12/13/85	2/25/86.
5. Columbia Gas Transmission Corp.*	CP86-240	12/13/85	2/28/86.
6. Ozark Gas Transmission System	CP86-250	12/24/85	Pending.
7. Gas Transport, Inc.*	CP86-291	1/24/86	Do.
8. Valero Interstate Transmission Co.	CP86-300	1/30/86	Do.
9. Consolidated Natural Gas Co.	CP86-311	2/10/86	Do.
10. Erie Pipeline System (ANR Pipeline Operator)	CP86-330	2/14/86	Do.
11. Transylvania Pipeline Co., Inc. (Transco affiliate)	CP86-334	2/14/86	Do.
12. Seagull Interstate Corp.	CP86-364	3/7/86	Do.
13. Texas Eastern Gas Transmission Co.	CP86-379	3/13/86	Do.
14. Superior Offshore Pipeline Co.	CP86-387	3/17/86	Do.
15. Northern Border Pipeline Co.	CP86-395	3/19/86	Do.
16. Transco Offshore Gathering Co.	CP86-397	3/20/86	Do.
17. Transcontinental Gas Pipeline Corp.	CP86-405	3/28/86	Do.
18. Northern Natural Gas Co.	CP86-435	4/11/86	Do.
19. Washtenaw Pipeline Co.	CP86-445	4/15/86	Do.
20. Standard Gas Marketing Co.	CP86-449	4/16/86	Do.
21. Transco Gas Services Inc.	CP86-452	4/17/86	Do.
22. Moraine Pipeline Co.	CP86-492	5/12/86	Do

23. Mantaray Transmission Co.	CP86-507	5/21/86	Do.
24. Texas Gas Transmission Corp.	CP86-521	5/30/86	Do.
25. Sabine Pipe Line Co.	CP86-522	5/30/86	Do.
26. Iroquois Gas Transmission Co.	CP86-523	5/30/86	Do.
27. Kentucky-West Virginia Gas Co.	CP86-526	5/30/86	Do.
28. Tennessee Gas Pipeline Co.	CP86-534	6/3/86	Do.

* Company filed November 1, 1985, statement of intent to provide non-discriminatory transportation.

Ongoing Settlement Negotiations Which Involve No. 436

Company name	Docket number
1. Northern Natural Gas Company	RP85-206
2. Texas Gas Transmission Company	
3. ANR Pipeline Company	
4. Natural Gas Pipeline Co. of America	
5. Panhandle Eastern Pipe Line Company	RP85-194
6. Tennessee Gas Pipeline Co.	RP86-119

Note.—Tariff filings submitted 1/31/86 by El Paso Natural Gas Company; a settlement (Docket No. RP85-175) and revised tariffs (CP86-276) filed by Transwestern Gas Company only lay the Foundation upon which these companies may return and file formal Order 436 blanket certificate applications. Recent filings by intrastate companies owned by Oklahoma Natural Gas Pipeline are also considered preliminary filings not formal Order 436 applications.

37 FERC ¶ 61,252

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Docket Nos. RM86-3-003 through -068

CEILING PRICES: OLD GAS PRICING STRUCTURE

ORDER NO. 451-A

ORDER GRANTING REHEARING IN PART, DENYING REHEARING IN PART, AND CLARIFYING FINAL RULE

(Issued December 15, 1986)

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UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Martha O. Hesse, Chairman; Anthony G. Sousa, Charles G. Stalon, Charles A. Trabandt and C. M. Naeve.

Docket Nos. RM 86-3-003 through -068

CEILING PRICES: OLD GAS PRICING STRUCTURE

ORDER NO. 451-A

ORDER GRANTING REHEARING IN PART, DENYING REHEARING IN PART, AND CLARIFYING FINAL RULE

(Issued December 15, 1986)

I. INTRODUCTION

On June 6, 1986, the Commission issued Order No. 451 modifying the price structure of old natural gas pursuant to its authority under sections 104(b)(2) and 106(c) of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (1982), and adopting regulations governing implementation of the revised price structure. 51 Fed. Reg. 22,168 (June 18, 1986). The order became effective on July 18, 1986.[1] Numerous requests

[1] On July 18, 1986, the Commission stayed the effectiveness of Order No. 451 until July 30, 1986, at the request of the United States Court of Appeals for the Eighth Circuit. 35 FERC ¶ 61,067. The stay was granted in order to allow additional time for the court to consider a petition filed on July 1, 1986, by KN Energy, Inc. requesting issuance of a writ of prohibition or, alternatively, a writ of mandamus directing the Commission to vacate Order No. 451. On August 19, 1986, the Court denied KN's petition. *In re KN Energy, Inc.*, No. 86-1806 (8th Cir. Aug. 19, 1986).

for rehearing have been filed challenging virtually all aspects of Order No. 451. This Order No. 451-A denies rehearing of Order No. 451 for the most part. However, certain modifications to the implementing procedures are adopted and various provisions of the rule are clarified.

II. BACKGROUND

In November 1985, the Secretary of Energy, acting pursuant to section 403 of the Department of Energy Organization Act,[2] issued and transmitted to this Commission for its consideration and action a proposed rule to reform the pricing structure for certain categories of natural gas subject to ceiling prices under sections 104 and 106 of the NGPA. According to the Department of Energy (DOE), the separately vintaged pricing system for old natural gas established by the NGPA distorted price signals in the natural gas market, raised consumer prices above market-clearing levels, inhibited efficient production of least-cost supplies, and would, unless modified, result in the loss of some 11 trillion cubic feet of old gas reserves. DOE argued that overall prices for gas had not fallen to market-clearing levels, despite the current surplus of available supplies, due to the cushion provided by old gas ceiling prices and that as a result consumers had not realized the full benefit of market competition. DOE also argued that the NGPA's old gas pricing system failed to assign a reasonable share of the replacement cost of new gas supplies to purchasers of old gas and concluded that the old gas ceiling prices should be corrected to take into account current competi-

[2] 42 U.S.C. § 7173 (1982).

tion in natural gas markets. DOE therefore proposed that the Commission exercise its authority under sections 104(b)(2) and 106(c) of the NGPA to eliminate vintage-based pricing of old gas by establishing a uniform ceiling price equal to the highest current ceiling price for old gas, that being the post-1974 vintage, with a price of $2.57 per MMBtu as of June 1986.[3]

DOE also proposed a "good faith negotiation rule" under which "first sellers"[4] would be given a one-time right to request their purchasers to nominate a price the purchaser was willing to pay, up to the new ceiling. If the purchaser nominated the ceiling price, the sale would continue at the new ceiling price. If the purchaser nominated a lower price, the seller could accept the price and continue sales at that price. Alternatively, the seller could reject the nominated price, in which case sales would continue at the existing price, but the seller would have the right at any time to sell the gas to another purchaser at a higher price provided the sale was for a term of at least two years. In that event, the seller would be released from any further obligation in law or contract to the existing purchaser upon 30-days notice. DOE also proposed that the Commission exercise its authority under NGPA section 107(b) by establishing higher incentive prices for production enhancement gas and creating certain new categories of gas eligible for the higher incentive prices.

Notice of the proposed rule was issued in the *Federal Register* on November 25, 1985 (50 Fed. Reg. 48,-

[3] Under DOE's proposal the new ceiling price would continue to be adjusted for inflation each month. First sellers would be entitled to claim the new ceiling price only if authorized by contract. However, since approximately 90 percent of old gas is sold under contracts containing sufficient authorization in the form of indefinite price escalation clauses, most old gas producers would be entitled to claim the new ceiling price.

[4] *See* NGPA section 2(21), 15 U.S.C. § 3302(21) (1982).

540). On December 20, 1985, the Commission issued a notice establishing a schedule for public comments on the proposed rule.[5] The Commission requested comments by interested parties concerning the scope of Commission authority to implement the proposal, including the elements of the just and reasonable rate standard applicable to old gas prices, the operation of indefinite price escalation clauses in old gas contracts, the relationship of the proposed rule to the Commission's block billing proposal in Docket No. RM85-1-000 and the likely response of the market in developing old gas supplies. On February 26, 1986, the Commission issued a notice providing for the filing of reply comments and scheduling a two-day public conference for discussion of issues involved in the proposed rule.[6] Initial comments were filed by February 25, 1986, and reply comments were filed by March 27, 1986. Over 160 initial comments and over 40 reply comments were received from numerous producers, pipelines, and gas distribution companies, as well as DOE, the United States Department of Justice, consumer representatives, members of Congress, States, State regulatory agencies, Cities, trade and business associations, and individuals.

In Order No. 451, the Commission adopted DOE's old gas price proposal, establishing a new, alternative ceiling price of $2.57 per MMBtu for old gas subject to Commission jurisdiction under NGPA sections 104 and 106. The Commission also adopted a modified version of the good faith negotiation rule. The good faith negotiation rule proposed by DOE was modified by allowing purchasers, in response to price renegotiation requests of a first seller, to request price renegotiation of any gas sold under the contract placed on the bargaining table by the producer as well as all gas sold under other contracts with the same first seller which include any

[5] 50 Fed. Reg. 52,935 (Dec. 27, 1985).

[6] 50 Fed. Reg. 7,583 (Mar. 5, 1986).

old gas. Each party is allowed 60 days to respond to price nomination requests of the other party, and each party is given 30 days to respond to the other party's price nomination. If no agreement on repricing is reached, the producer may abandon sales to the purchaser and the purchaser may terminate its purchases. The effectiveness of the good faith negotiation rule was deferred until November 1, 1986, in order to enable both purchasers and first sellers to become familiar with its terms and to encourage contracting parties to enter into voluntary contract renegotiations in lieu of mandatory renegotiation under the good faith negotiation procedures.[7] Abandoning producers were granted blanket certificates of public convenience and necessity authorizing the sale of gas abandoned or released under the rule, and rate filing requirements were waived for such sales. DOE's proposals to require that any sale of abandoned gas be for a term of at least two years and at a price higher than that offered by the existing purchaser were not adopted. The Commission instead provided firm sales customers of interstate pipelines with a right of first refusal enabling them to purchase abandoned or released gas by agreeing to meet the terms offered by any potential third-party purchaser. Interstate pipelines which are not open-access transporters under Order No. 436[8] were

[7] On July 17, 1986, the Commission issued an Interim Order on Rehearing to confirm that contract amendments may be made outside the good faith negotiation procedures. 36 FERC ¶ 61,058. The Commission has aslo delayed the date on which good faith negotiation may be initiated until December 18, 1986. 37 FERC ¶ 61,077.

[8] Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Docket No. RM85-1-000, Order No. 436, 50 Fed. Reg. 42,408, 42,372 (Oct. 18, 1985), corrected at 50 Fed. Reg. 45,907 (Nov. 5, 1985); Order No. 436-A, 50 Fed. Reg. 52,217 (Dec. 23, 1985); Order No. 436-B, 51 Fed. Reg. 6398 (Feb. 24, 1986); Order No. 436-C, 51 Fed. Reg. 11,566 (April 4, 1986); Order No. 436-D, 51 Fed. Reg. 11,569 (April 4, 1986); Order No. 436-E, 51 Fed. Reg. 11,566 (April 4, 1986); appeals docket *sub nom.* Associated Gas Distributors *et al.* v. FERC, Nos. 85-1811 *et al.* (D.C. Cir.).

granted blanket transportation authorization and are deemed to have agreed to transport abandoned or released gas to their existing customers or to interconnected pipelines. Action on DOE's incentive price proposal was deferred pending further Commission review.

III. REQUESTS FOR REHEARING

The Commission received 62 requests for rehearing challenging virtually every aspect of Order No. 451. (*See* Appendix A.) Applicants seeking rehearing argue variously that in adopting the rule the Commission exceeded the scope of its authority, that even assuming sufficient authority, the rationales for the rule are inadequate or invalid, that various provisions of the rule are unlawful, that the rule is unbalanced in favor of particular categories of affected parties, and that various terms and provisions of the rule require clarification. The Commission has reviewed the arguments set forth in the rehearing requests and concludes they do not justify making any significant changes in the basic terms of the rule. However, the Commission agrees that certain modifications should be made, mostly involving the procedures of the good faith negotiation rule and transportation rates. The Commission also grants numerous requests for clarification of various terms and provisions of the rule.

IV. DISCUSSION OF REHEARING ISSUES

A. *Commission Authority*

In Order No. 451 the Commission acted to reform the price structure of old gas under the authority of sections 104(b)(2) and 106(c) of the NGPA and rejected arguments of various commenters that Congress' incorporation in the NGPA of the prices and price structure for old gas in effect prior to enactment of the NGPA deprived the Commission of authority to alter that structure under the authority of the Natural Gas Act (NGA).

The Commission concluded that the terms of sections 104 (b)(2) and 106(c) are unambiguous and specifically authorize the Commission to modify the prices and price structure of old gas, subject only to the just and reasonable standard of the NGA.

Requests for Rehearing. Numerous rehearing applicants reiterate the arguments made in their comments that sections 104(b)(2) and 106(c) do not provide authority for the Commission's promulgation of a single maximum lawful price for all old gas, and the consequent elimination of the system of tiered prices based on the date the wells were drilled.[9] Applicants argue that Congress intended to leave old gas under the largely original-cost-based price ceilings in effect at the time of enactment of the NGPA in order to protect consumers from the effects of deregulation of new gas prices and prevent a financial windfall to producers of old gas, while at the same time stimulating addition of new reserves, and that the Commission's action in Order No. 451 is thus at odds with the basic purpose and design of the NGPA.

Applicants argue that the Commission's authority to increase old gas prices under sections 104(b)(2) and 106(c) is limited to applying the rate-making principles embodied in the last producer rate orders issued by the Federal Power Commission before enactment of the

[9] United Distribution Companies (UDC) at 15-37; American Public Gas Association (APGA) at 12-20; Maryland Peoples Counsel/National Association of State Utility Consumer Advocates (MPC NASUCA) at 6-13; KN Energy, Inc. (KN) at 13-17; Northern Natural Gas Company (Northern Natural) at 5-10; Florida Cities at 5-6; Public Service Commission of New York (N.Y. PSC) at 2-8; Public Service Commission of the District of Columbia (D.C. PSC) at 8-13; Interstate Natural Gas Association of America (INGAA) at 6-7; Michigan and the Michigan Public Service Commission (Michigan) at 2-5; Laclede Gas Company (Laclede) at 2-6.

NGPA, Opinion Nos. 770 and 770-A.[10] These orders modified a decision in the previous national rate order, Opinion No. 699-H,[11] to gradually eliminate vintaging, and re-established a vintaged-based price structure for old gas. Applicants argue, therefore, that the Commission now lacks authority to eliminate the system of vintage pricing adopted in Opinion No. 770 or to base old gas ceiling prices on cost methods different from those from which the old gas prices adopted in that proceeding were derived. UDC argues that the Commission had never adopted a purely replacement-cost-based rate for old flowing gas prior to enactment of the NGPA and that Congress, therefore, could not have intended to allow the use of this methodology to raise ceiling prices for old gas under the authority of section 104(b)(2) of the NGPA.[12]

Several applicants argue that the United States Supreme Court's discussion of the NGPA in *Public Service Commission of New York v. Mid-Louisiana Gas Co.*[13] supports the conclusion that the Commission may increase old gas prices under the authority of sections 104 (b)(2) and 106(c) only when traditional NGA principles would dictate a higher price, such as when costs have increased at a rate in excess of the statutory inflation adjustment.[14] UDC cites *Mid-Louisiana* for the proposition that the vintaged price structure for old gas became unalterable upon passage of the NGPA:

> The statute evinces careful thought about the extent to which producers of 'old gas'—the gas already dedicated to interstate commerce before passage of the

[10] 56 FPC 509 (1976) and 56 FPC 2698 (1976).

[11] 52 FPC 604 (1974).

[12] UDC at 17-20.

[13] 463 U.S. 319, 333-35 (1983).

[14] UDC at 31-33; MPC NASUCA at 11-12.

NGPA—would be able to enjoy incentive pricing. Section 104 of the statute directly incorporates part of the 'vintaging' pattern that previously existed under the NGA.[15]

Several applicants argue that the Commission's authority under sections 104(b)(2) and 106(c) is limited to granting "special relief" on a case-by-case basis, where the otherwise applicable ceiling prices are insufficient to allow producers to recover their production costs.[16] These applicants cite a Commission order terminating a proposed rulemaking on special relief regulations where sections 104(b)(2) and 106(c) were described as providing authority under the NGPA to continue granting special relief in accordance with procedures and standards developed under the NGA.[17] The PUC of California also cites *Interstate Natural Gas Association of America v. FERC*[18] for the proposition that Congress did not intend to permit the Commission to raise old gas prices across the board, but only on a case-by-case basis.[19]

Other applicants argue that because the new ceiling price is well above current market prices for natural gas, Order No. 451 constitutes *de facto* deregulation of old gas, in contravention of Congress' intent under the NGPA to leave old gas "forever regulated."[20] These

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[15] 463 U.S. at 334.

[16] D.C. PSC at 8-9; California Public Utilities Commission (Cal. PUC) at 15-17; Southern California Gas Company (SoCal) at 10-12.

[17] FERC Statutes and Regulations, Regulations Preambles (1982-1985), ¶ 30,565 at 30,928.

[18] 716 F.2d 1 (D.C. Cir. 1983), *cert. denied*, Exxon Corp. v. Interstate Natural Gas Assoc., 465 U.S. 1108 (1984).

[19] PUC of California at 16.

[20] Northern Natural at 11-13; Minnesota Department of Public Safety (Minnesota DPS) at 2-3; INGAA at 8-9; APGA at 16-17; Kansas Power & Light Company (KP&L) at 14-16; N.Y. PSC at 13-15.

applicants note that the Commission repeatedly asserted its goal of providing for "market-responsive prices" for old gas by means of the regulations promulgated in Order No. 451. They argue, however, that the Supreme Court has construed the NGA as prohibiting the Commission's reliance on prevailing prices in the marketplace to determine just and reasonable rates, citing *FPC v. Texaco, Inc.*[21]

Commission Response. The Commission recognizes that section 104(b)(1) of the NGPA was intended to directly incorporate the just and reasonable rates, and thus the cost-based prices according to vintage, in effect at the time of the NGPA's enactment. Further, the Commission agrees that Congress considered this provision for old gas prices to be a significant feature of the NGPA's design, intended to mitigate the effects on consumers of allowing higher prices for new gas. The Commission expressed the same rationale for its decision to retain vintage-based rates in Opinion No. 770. However, the applicants have not cited, nor has the Commission found, any legislative history whatsoever on section 104(b)(2),[22] or the virtually identical sections 106(c) and 109(b)(2), that raises any doubt about its plain meaning. If Congress had intended old gas prices to be forever subject to the ceilings in effect when the NGPA was enacted, subject only to the statutory inflation adjustment, sections 104(b)(2) and 106(c) would not have been included in the NGPA. The authority granted to the Commission under these provisions to increase old gas prices above the otherwise applicable maximum lawful prices is too clear to admit any doubt. By inclusion of these provisions, Congress authorized the Commission to review and revise old gas prices in light of current conditions. The *only* limitations imposed by section 104(b)(2) on

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[21] 417 U.S. 380 at 397-99 (1978).

[22] 15 U.S.C. § 3314(b)(2) (1982).

the Commission's authority to restructure old gas prices is that such prices must be just and reasonable within the meaning of the Natural Gas Act and may not be lower than the ceiling prices established under section 104(b)(1).

Nothing in section 104(b)(2) or the NGPA's legislative history supports the applicants' argument that Congress intended to limit the scope of the Commission's discretion under the NGA to utilize whatever methodology it chooses to establish rates for old gas, so long as the end result is just and reasonable. The record of the debates on the NGPA demonstrates that Congress was clearly aware of the broad scope of that discretion. Senator Abourezk, for example, stated during the Senate's debate on the NGPA on September 19, 1978:

> In addition, it is critical to point out that the law [NGA] does not require that the price set by the FERC be cost-based, except that, in the absence of full cost justification, the FERC must show the tangible benefits to consumers. This is the "end result test" established in FPC against Hope Natural Gas Co. . . .
>
> Nothing prevents FERC setting the rate at whatever level is necessary actually to elicit new supply. . . .[23]

Senator Kennedy also stated, later the same day:

> I want to remind Senators that the means of increasing production is already available in the form of the Federal Energy Regulatory Commission Authority. Sufficient authority already exists to establish prices which will being forth gas at a "just and reasonable" price and to vary that price according to conditions.[24]

[23] 124 Cong. Rec. 30,018 (Sept. 19, 1978).

[24] 124 Cong. Rec. 30,023 (Sept. 19, 1978).

However, except for the proscription against reducing old gas prices from the ceilings otherwise applicable under sections 104(b)(1) and 106(b), Congress did not limit the Commission's authority to establish old gas prices under the just and reasonable standard of the NGA.[25]

The statements by the Supreme Court in *Public Service Commission of New York v. Mid-Louisiana Gas Co., supra*, do not support the applicants' assertions that the Commission lacks authority under section 104(b)(2) to eliminate vintage pricing for old gas. In *Mid-Louisiana* the Court held that interstate pipelines that owned gas wells were entitled to have their intra-corporate transfers of gas treated as "first sales" and thus be subject to the pricing provisions of the NGPA. The statement from *Mid-Louisiana*, quoted above, is part of a general description of the NGPA's pricing provisions and not a holding on the scope of the Commission's authority. The Court accurately described section 104(b)(1) as directly incorporating the existing pattern of vintaged prices. However, the Court also referred to section 104(b)(2): "[T]he statute recognizes that the ceiling [under section 104(b)(1)] may be too *low* and authorizes the Commission to raise it whenever traditional NGA principles

[25] While the Commission has asserted that section 104(b)(2), 106(c), and 109(b)(2) provide authority to grant special relief in the form of higher prices for old gas from certain wells or leases, it has never suggested that the authority granted by these provisions is limited to granting relief on a case-by-case basis. FERC Statutes and Regulations, Regulations Preambles (1982-1985) ¶ 30,565. Nor is this authority so limited by the decision of the United States Court of Appeals for the D.C. Circuit in Interstate Natural Gas Association of America v. FERC, *supra*, that the Commission lacked authority under the NGPA to allow higher prices for natural gas by altering the standard for measuring its Btu content. Section 104(b)(2) specifies circumstances where the Commission is authorized to increase gas prices, without limiting the exercise of that authority to individual cases.

would dictate a higher price." [26] As discussed more fully in succeeding sections, the Commission in this proceeding has revised the old gas price structure on the basis of reasonable and previously approved principles of regulation fully consistent with the just and reasonable standard of the NGA and the Court's comments in *Mid-Louisiana.*

While the Commission recognizes the benefits of market-responsive prices in a competitive environment, it does not in this proceeding rely exclusively on market forces to establish just and reasonable prices. Thus, the price of old gas has not been deregulated *de facto* or otherwise. Order No. 451 allows for sales of old gas *to be* negotiated in light of current market conditions, but with a protective ceiling price based on long-term replacement costs. Because current market prices for natural gas are *generally* below the alternative ceiling price established for old gas by Order No. 451, the good faith negotiation procedures are expected to result in prices for old gas that are market-responsive. However, old gas prices can respond to market forces only within the just and reasonable ceiling price, and thus remain regulated.

The Supreme Court's decisions in the *Mobile* and *Sierra* cases [27] established the doctrine, preserved in this proceeding, that the agreement of the parties sets the lawful rate for a utility service under the NGA, so long as the contract rate does not exceed the rate found just and reasonable by the Commission. Thus, market forces will operate within the regulated ceiling price for old gas under Order No. 451 as under any other rate ceiling established by the Commission under the NGA, or under NGPA ceiling prices for other categories of gas.

[26] 319 U.S. at 333 (emphasis in original).

[27] United Gas Pipe Line Co. v. Mobile Gas Corp., 350 U.S. 332 (1956); FPC v. Sierra Pacific Power Co., 350 U.S. 348 (1956).

B. *Old Gas Price Structure*

In the final rule the Commission determined that the record in this proceeding demonstrated that the old gas price structure was a principal source of market distortion, that it caused producers to abandon prematurely easily accessible supplies, and caused consumers to react to misleading market signals. The Commission concluded that the old gas price structure was a central factor contributing to current market anomalies, characterized by falling wellhead prices, unresponsive citygate prices, fuel switching, loss of loads, and excess production and transmission capacity. The Commission therefore determined that the old gas price structure was unjust and unreasonable and should be abolished.

In adopting the final rule, the Commission confirmed the view that the then-existing old gas price structure was outmoded, and characterized by distortions, inequities, inefficiencies and disincentives, that demanded reform.[28] Prior to issuance of Order No. 451, it had been nine years since the last national ratemaking was completed. Thus, the economic data and information concerning replacement costs, commodity values, and other factors which were considered by the Commission in formulating the old gas prices had been overtaken by events, which include the current market realities of excess deliverability and declining investment in exploration and development and the imperative need for national energy self-sufficiency. The former system of vintaged rates for old gas failed to accurately reflect the cost and market

[28] The former price structure for old gas consisted of 15 separate categories based for the most part on the vintage-based price categories and related prices established by the Commission in national rate proceedings in Opinion Nos. 749 (pre-1973 gas) (54 FPC 3090 (1975)) and 770-A (post-1972 gas) (56 FPC 2698 (1976)) and which were in effect as of April 1977. These rates were incorporated in the NGPA, subject to increase by the Commission to a new maximum lawful price, if just and reasonable within the Natural Gas Act.

value of certain categories of old gas; thus, it discouraged production of old gas reserves, reflected an unwarranted disparity between old and new gas prices, was unnecessarily complex, and caused distortion in the market because of the unequal access of pipelines and distributors to various categories of old gas supplies.

The Commission found most persuasive studies showing that if current old gas prices were held at their present levels, approximately 11 Tcf of old gas reserves would not be produced. The 11 Tcf of old gas reserves not produced as a result of vintaging would have been replaced by higher-priced energy supplies. In part these incremental supply requirements would be met by foreign imports of both oil and gas and the nation's energy security would thereby be compromised and its trade balance weakened. Regardless of the source of the incremental supplies, however, the nation's energy users would be required to pay more for these incremental supplies than would be necessary.

The Commission utilized as one basis for judging the just and reasonableness of the NGPA old gas prices, the four criteria employed by the Commission in its notice requesting supplemental comments in Docket No. RM85-1-000 (Part D), issued on October 9, 1985.[29] Under these standards, a just and reasonable rate must (1) permit efficiency in the production and consumption of natural gas, (2) permit fair competition, (3) prevent wasteful depletion, and (4) respond to changing conditions in the industry. The former vintaged old gas prices failed to meet these standards and were therefore found no longer just and reasonable.

Requests for Rehearing. A number of rehearing applicants challenge the Commission's findings concerning the price structure of old gas.[30] A large number of these parties continue to argue that the major cause of distortion in the natural gas market is the rigidity of existing contract relationships, not vintaging. They also argue that the Commission appears at one time to have shared this view—notably in Order No. 436—and that the Commission's "change" of position is inconsistent.[31] In this vein, Northwest Central asserts that the Commission acted arbitrarily "in failing to resolve issues involving new gas with above-market prices and high take-or-pay contracts." [32] Putting it another way, KP&L asserts that the Commission's finding that the vintaging pricing structure is responsible for current market disorders was arbitrary.[33] NI-Gas appears to acknowledge as beneficial the fact that Order No. 451 addresses the causes of distortion (vintage rates), but argues that the rule provides "no symptomatic relief" [34] from contracts.

MPC/NASUCA renew assertions that the competitive advantages associated with disproportionate access to the old gas vintages no longer exist. MPC/NASUCA confirm that what they refer to are the bidding wars of the 1978-1981 period of relative supply scarcity. During that period, pipelines with relatively larger cushions of old gas vintages were able to outbid their competitors, not on the basis of efficiency of operation and management, but solely based on the amount of "old" gas they could roll-in without adversely affecting their weighted average cost

[29] 50 Fed. Reg. 42,372 (Oct. 18, 1985).

[30] Associated Gas Distributors (AGD) at 8; The Kansas Power and Light Company, Kansas Public Service Company, and Missouri Public Service Company (KP&L *et al*) at 26-27; (MPC NASUCA at 24-26; Northern Natural at 9; D.C. PSC at 4; Northern Illinois Gas Company (NI-Gas) at 9; Interstate Power Company at 4; KN at 15-17; Northwest Central Pipeline Corporation (Northwest Central) at 23-24; Midwest Energy Inc. (Midwest) at 4-5.

[31] AGD at 8; KP&L *et al.* at 26-27.

[32] Northwest Central at 27.

[33] KP&L *et al.* at 27.

[34] NI-Gas at 9.

of gas (WACOG) vis-a-vis other pipelines.[85] Since all WACOG's are now above market-clearing levels, MPC/NASUCA insist that the distorting effects of what they admit are "artificially low prices" [86] have been expended.

KN aserts that because Congress incorporated "part of the vintaging pattern" into the NGPA, the Commission no longer has the discretion to eliminate vintaging, even if it did have that discretion under the NGA. KN claims that the Commission's staff "acknowledged the fact that the Commission has no clear legal authority to eliminate vintaging," [87] in the staff analysis attached to the 1982 Notice of Inquiry in Docket No. RM82-26-000.

Finally, a number of applicants take issue with the Commission's perception that the old gas "cushions" enjoyed by some pipelines are the result of historical accident. Northern Natural, for example, asserts that the cushions "in most cases" reflect years of prudent and effective management.[88]

Commission Response. Applicants have generally raised arguments previously made in comments and reply comments to the final rule. The Commission has already considered and disposed of these arguments. The Commission finds nothing new that would impel it to change its determination that the old gas vintage price structure had become unjust and unreasonable and should therefore be replaced.

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[85] *See* Order No. 451, 51 Fed. Reg. at 22,181 and n.110.

[86] MPC/NASUCA at 25.

[87] KN at 13-17 *citing* Staff Analysis, Impact of the NGPA on Current and Projected Natural Gas Markets (Notice of Inquiry), IV FERC Stats. & Regs. ¶ 35,512 at 35,573-74 (1982). KN's assertions related to the Commission's authority to eliminate vintaging has already been addressed in Part IV. A., *supra.*

[88] Northern Natural at 9. *See also* Interstate Power Company at 4; Midwest at 4-5.

The Commission reaffirms that the former ceiling price structure for old gas is the *primary* cause of continuing price distortions to consumers in natural gas markets. This is not to say it is the *only* cause.

The former old gas prices distorted consuming patterns in two ways. First, consumers supplied by pipelines with access to large quantities of the below market-priced vintages are misled into the false belief that they can continue to buy incremental units of gas for less than the true market price. These pipelines are then required to meet their customers' demands by bidding up the price of new gas. Second, consumers supplied by pipelines with limited access to low-priced categories of gas are required to pay higher than necessary prices because these pipelines have to purchase incremental supplies whose price has been distorted by pipelines who had large quantities of below market-priced gas and who have bid up the price of new gas to meet their own customers' demands. Consequently, customers of high cost pipelines have attempted to switch to either less expensive gas supplies or alternative fuels when able, thus causing their original pipeline supplier to lose load and attempt to shift costs to those customers without the ability to switch supplies or fuels. Likewise, customers supplied by pipelines with access to large quantities of the below market-priced vintages will not consider the use of alternative supplies even though those supplies may be cheaper when the incremental supplies' marginal cost is compared with the marginal cost being paid by their pipeline supplier.

These same price signal distortions also distort producers' exploration, development and production decisions. Specifically, producers selling new supplies find that pipelines endowed with a below-market cushion of old gas are willing to pay otherwise above-market prices in order to secure new supplies to meet their growing demand. This in turn encourages the development of more new high-cost marginal supplies at costs which ex-

ceed that which an undistorted market would be willing to pay, while producers of below-market-priced old gas vintages are discouraged from making investments needed to maximize production of easily available production from existing fields. Correcting these distortions which arise primarily from the old gas price structure was the central purpose of the notice of inquiry in Docket No. RM82-26-000,[39] was integral to the proposal in Docket No. RM85-1-000,[40] and was finally accomplished in Order No. 451.[41] Notwithstanding the assertions of certain applicants to the contrary, the Commission has neither changed positions nor been inconsistent. The elimination of vintaging, coupled with the good faith negotiation process, will help bring economic rationality and more competition to the natural gas markets and will provide a framework for overhauling rigid contract structures. In the more economically rational market-responsive environment created by Order No. 451, lower cost gas will be produced first, and higher cost gas produced only later, as needed.

Applicant NI-Gas is correct, in at least acknowledging that Order No. 451 addresses the root causes of market

[39] *See* Order No. 451, 51 Fed. Reg. at 22,181 n.105 (June 18, 1986).

[40] *Id.* at 22,182 ("[V]intaging is the major cause of the market distortions identified by the Commission in Docket No. RM85-1-000. . . .").

[41] AGD argues that in Order No. 436, the Commission attributed market disorders to rigid contracts, but in Order No. 451 attributed them to the vintage pricing system. Since Order No. 436's "principal mission" was market analysis, the Order No. 436 approach should have been adopted according to AGD. Yet the approach of Part D of Order No. 436 dealt by indirection with the problem the Commission addressed directly in Order No. 451. Thus there was no divergence from the "mission" of Order No. 436 as alleged by petitioner AGD. *See* AGD at 8. Both orders have a role to play in developing a more market-responsive industry framework. *See also* part V. B. *infra*.

distortion by collapsing the vintage rates, than are those applicants such as AGD who insist that the contractual "symptoms" of vintaging are the root problem. Treating the cause of an ailment will provide relief from the symptoms in due course. The Commission cannot concur that Order No. 451, by treating vintaging as a root cause, provides no symptomatic relief whatsoever for these contract problems. Under the good faith negotiation process established by the rule,[42] pipelines as well as producers may effect the renegotiation of many "problem" contracts entered into in the context of the old vintage structure. Moreover, Order No. 451 provides room for and encourages negotiations outside of the good faith negotiation process.[43] Thus Order No. 451 addresses both the primary cause and the symptoms of the existing market distortions. AGD, KP&L, and Northwest Central's assertions of inconsistency with, or departure from, Order No. 436 and the Notice of Inquiry are therefore without merit.

The Commission must similarly reject again the contentions of those petitioners such as MPC/NASUCA, who assert that the distortions engendered by the vintage structure no longer exist. MPC/NASUCA admit the old vintages were "artificially low" and had a distorting effect in the past.[44] MPC/NASUCA confirm the Commission's assumption in Order No. 451 that the distortion they refer to is a narrower concept than the Commission's, because it is limited to the immediate effects of the bidding wars of the 1978-1981 period of relative supply scarcity. During that period, pipelines were able

[42] Order Nos. 451, 51 Fed. Reg. 22,204-09 (June 18, 1986).

[43] *See also* Interim Order On Rehearing, issued July 17, 1986, Docket No. RM86-3-002, 36 FERC ¶ 61,058, designed to encourage voluntary renegotiation by clearly permitting contract amendments, if the parties desire, without loss of rights under the good faith negotiation rule.

[44] MPC/NASUCA at 25.

to bid-up new supplies to distorted, above-market levels by "rolling-in" the old gas with the new. In response to applicant MPC/NASUCA's insistence that the distorting affect of the "artificially low" vintage has dissipated, the record in this proceeding demonstrates the continuing correlation betwen various pipelines' access to cushion gas and the pipelines' WACOGs. Unless the vintage structure is corrected now, during a transient period of opportunity when bidding-up of new gas and ability to roll-in high price new supplies with old gas has temporarily subsided, the cycle could repeat itself. Pipelines with low WACOGs have an inherently distorting impact on the market, because they need not contract for new gas supplies based on any fair measure of competitive equality. Far from being dissipated, the distortions inherent in having the old vintages priced "artificially low" thus persist today, and would be renewed to full vigor as the gas bubble dissipates and supplies tighten in the years ahead. The current decline in rig counts [45] testifies to the danger of the full-blown reappearance of these now quiescent distortions.

Current market realities make it plain that there will not likely be extensive new investment in order to add additional high cost supplies at this time. The most efficient way of adding incremental supplies is to stimulate production of low-cost gas, which represents an assured and reliable supply available at the lowest reasonable cost. Therefore the Commission took action to provide the incentive to produce these reliable low cost supplies by establishing the new just and reasonable rate for such gas in the final rule.

In addition, gas from wells with low price ceilings may be prematurely abandoned and resources lost absent the elimination of below-market price ceilings. The

[45] Hughes Rig Count as of Nov. 11, 1985 was 1,895; as of Nov. 10, 1986 it declined to 874. See Oil & Gas Journal, Week of Nov. 17, 1986, at 76.

sooner these distortions are eliminated, and a more market-responsive environment allowed to develop under the negotiation initiatives encouraged by Order No. 451, the better. Otherwise, some resources will remain under-produced, or even permanently lost, while other, marginal resources are developed at higher cost and before they are needed. Consumers on deep cushion pipelines will continue to be misled as to the true cost of replacing the gas they consume, while consumers on pipelines less well-endowed will continue to pay higher prices for their supplies.

KN's assertion that the staff analysis attached to the 1982 Notice of Inquiry in Docket No. RM82-26-000 "acknowledged the fact that the Commission has no clear legal authority to eliminate vintaging" is puzzling, when actually the staff concluded that "the Commission probably has the legal authority to eliminate vintaging, if such elimination is found to be just and reasonable, by setting a single just and reasonable rate for all gas currently vintaged." [46] The analysis goes on to note the alternative adoption and elimination of vintaging in the past, the court's approval of the Commission's discretion in this regard, and the policy imperatives that would support elimination of the NGPA vintages as follows: [47]

> The Commission alternatively embraced and backed away from vintaging throughout the 1960's and 1970's. The elimination of vintaging has, therefore, been considered by the Commission and reviewed by the courts on several occasions.
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> * * * *
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> On judicial review of Opinion No. 699-H, the Court recognized that the Commission was not bound by its

[46] Appendix A.—Staff Analysis, Impact of the NGPA on Current and Projected Natural Gas Markets (Notice of Inquiry), IV FERC Stats. & Regs. ¶ 35,512 at 35,573 (1982).

[47] *Id.* at 35,573-74.

> previous vintaging policies, but that the Commission should "be permitted latitude to evaluate old experiments and modify or abandon them when [its] best judgment require[s] such course of action." [*Shell Oil Co. v. FPC*, 520 F.2d 1061, 1077-78 (5th Cir. 1975), *cert. denied*, 425 U.S. 941 (1976).]
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> * * * *
>
> [T]he principal difference between eliminating vintaging and not eliminating vintaging would not be the average price paid by consumers, but the distribution of wealth among producers and the ability of interstate and intrastate pipelines to compete with and among one another for new supplies. [footnote omitted.]
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> * * * *
>
> Finally, vintaging may discriminate unreasonably against customers of pipelines that have a much smaller price cushion. If pipelines with low weighted average costs are in a better position to obtain new supplies, their customers are more certain of delivery of their supplies and lower prices. This advantage is the result of a pipeline's historical, fortuitous opportunities to contract for large volumes of low-priced vintaged gas and bears no rational relationship to its customers' demands or priority uses.

If anything, this analysis supports the final rule as issued and the rationales therein. Far from being an abrupt departure in policy, Order No. 451 should be understood as the culmination of a long study of the market-ordering problem, begun in the 1982 Notice of Inquiry.

Finally, the Commission disagrees with the assertions of Northern Natural and others that the disparity among pipelines' old gas cushions in most cases reflects more prudent and effective management by those pipelines endowed with the larger cushions.[40] While some pipeline managements may have been more effective in negotiating for lower price supplies than others, a far more important factor was the fortuitous geographic location of certain pipelines near plentiful low-cost supplies subject to lower vintage prices. Moreover, the Commission anticipates that after Order No. 451 is fully implemented, and "the dust has settled" somewhat, those pipelines will continue to benefit from proximity to such fields and this advantage will be reflected in relatively lower WACOG's for such pipeline systems vis-a-vis competing pipelines. While the final rule will not result in absolutely level WACOG's, it should reduce the current spread in gas prices that comprise these WACOGs, by providing a framework for moderate increases in some old gas prices and commensurate reductions in some new gas prices. The final rule, by contributing to a more economically efficient market will benefit those managements that are most genuinely competitive and skillful by increasing their access to gas that may now be shut-in, and will enable them to bring that gas to market.

C. *Ceiling Price*

In Order No. 451 the Commission adopted DOE's proposal to establish the old gas ceiling price at a level equal to the existing ceiling price for post-1974 gas. That price was $2.57 per MMBtu as of June 1986, and is currently $2.61 per MMBtu. In selecting the post-1974 vintage rate as the ceiling price for old gas, the Commission relied on the theory of replacement cost pricing. The Commission found that prices based on replace-

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[40] Midwest Energy Inc. (Midwest) is wrong in assuming that the Commission intended to suggest that KN and other pipelines with low WACOGs "secured their present low cost status by sharp or improper practices." Midwest at 4. Rather, the Commission views artificially low WACOGs on some systems as primarily adventitious, with management decisions having some effect on what is essentially a fortuitous phenomenon.

ment cost were necessary to assure an adequate long-term supply of natural gas, to eliminate distortion and excessive disparity in prices as between new and old gas prices, and to make the price structure of natural gas more economically efficient. (51 Fed. Reg. at 22,186-87). The Commission relied on the fact that the FPC had approved eventual pricing of all natural gas, including old flowing gas, at replacement costs levels, and the resulting elimination of vintaging, in the first national producer rate proceedings, Opinion No. 699-H,[49] was affirmed by the courts.[50]

In determining whether DOE's proposed ceiling price was representative of current replacement costs, the Commission reviewed the discounted cash flow (DCF) methodology used by the FPC in Opinion No. 770 to establish the post-1974 vintage rate. The Commission also considered an updated Opinion No. 770 DCF cost study submitted by Indicated Producers. The Commission concluded that the long-term replacement cost of gas was within a range between the post-1974 vintage rate of $2.57 per MMBtu (as of June 1986) and the Indicated Producers' updated replacement cost estimate of $2.77 per MMBtu. The Commission selected the post-1974 vintage ceiling price as the ceiling price for old gas. The Commission stated that while the $2.57 per MMBtu rate might not reflect post-1976 DCF inputs as accurately as the Producers' study, the lower estimate was more reasonable under the circumstances because it recognizes that any prediction of replacement cost is subject to constant change in input variables and that adopting the lower estimate would protect consumers.

The Commission emphasized that the post-1974 rate adopted would operate only as a ceiling price, and that

[49] 52 FPC 1604 (1974). See also Opinion No. 639, 48 FPC 1299 (1972).

[50] Shell Oil Co. v. FPC, 520 F.2d 1061 (5th Cir. 1985), *cert. denied* 426 U.S. 941 (1976).

prices actually paid for old gas in the market pursuant to the good faith negotiation rule are likely to be substantially below the ceiling price as long as the current deliverability surplus continues. At such time as the market clears and supply and demand come into balance, the market price for old gas will increase. When this happens, the ceiling price will prevent market forces from driving the price of old gas above the level of replacement costs and will thus assure that old gas prices remain just and reasonable.

Requests for rehearing. Numerous parties seek rehearing of the Commission's decision in Order No. 451 to adopt a ceiling price for flowing gas based on replacement costs.[51] These parties argue that old gas prices must be based, either wholly or at least in part, on historical or original costs. Many rehearing applicants cite *City of Detroit v. FPC*, 230 F.2d 819 (D.C. Cir. 1956), and *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984), in support of the claimed need to rely on historical costs. They further argue that the Commission in Order No. 451 erroneously relied on certain FPC and judicial decisions, notably FPC Opinion Nos. 699-H and 749 and their respective affirming court decisions, *Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975), and *Tenneco Oil Co. v. FERC*, 571 F.2d 834 (5th Cir. 1978), as supporting reliance on replacement costs in establishing old gas ceiling prices.

Rehearing applicants also argue that even if replacement cost pricing of old gas could be justified in theory,

[51] American Gas Association (AGA) at 5-7; INGAA at 4-7; UDC at 15-31; AGD at 2-3; Northern Distributor Group (NDG) at 3-5; Cal. PUC at 17-20; N.Y. PSC at 2-10; Texas Eastern Transmission Corporation (Texas Eastern) at 25-31; Florida Cities at 6-18; Southern Natural Gas Company (Southern Natural) at 6-11; Southern California Gas Company (SoCal) at 12-15; KP&L *et al.* at 6-9; Laclede at 6-13; Peoples Gas Light and Coke and North Shore Gas Company (Peoples Gas *et al.*) at 4-10.

the record in this case does not support such a policy. They argue that the FPC's decision in Opinion No. 699-H to grant higher prices for old gas and phase out vintaging were based on a finding made by the Commission and accepted by the reviewing court that in light of the natural gas shortage which then existed, a massive infusion of funds was required to help finance the search for new supplies. These parties argue that since gas deliverability now exceeds demand, there is no reason to believe that producers need additional revenues from sales of old gas to finance increased levels of exploration. It is alleged that under these circumstances, raising the ceiling price for old gas results in windfall profits for producers of old gas.[82]

A number of rehearing applicants also argue that the ceiling price adopted by the Commission has not been shown to accurately represent current replacement costs and that the Commission's finding in Order No. 451 that the post-1974 rate is representative of current replacement costs is not supported by substantial evidence.[83] They argue, for example, that the Commission failed to consider evidence that gas production costs, inflation rates and fuel prices have changed significantly since the Opinion No. 770 replacement cost formula was adopted and that, in particular, the cost of drilling for gas had declined in real terms since Opinion No. 770 was issued in 1976.[84] They argue that rather than relying on the Opinion No. 770 cost analysis adjusted for inflation or the updated study submitted by Indicated Producers, the Commission should have prepared an independent calcu-

[82] UDC at 31; Cal. PUC at 14; Florida Cities at 11; Southern Natural at 11; SoCal at 14; Peoples Gas *et al.* at 19; KP&L *et al.* at 16.

[83] AGA at 8-10; AGD at 3-4; Minnesota DPS at 4-5; SoCal at 15-16; Peoples Gas *et al.* at 21-22.

[84] AGA at 8; INGAA at 8; KP&L *et al.* at 24; SoCal at 16.

lation of current replacement costs.[85] Several parties also allege procedural errors in the Commission's consideration and determination of the ceiling price issue.

Commission response. In the Commission's judgment, the arguments presented on the replacement cost issue are without merit and do not justify modifying the old gas ceiling price adopted in Order No. 451. The Commission has previously considered and rejected assertions by the rehearing applicants that the Commission's authority to approve rates as just and reasonable under the NGA has been circumscribed as the result of enactment of the NGPA and that as a consequence the Commission may not adopt rate methodologies different from those used to determine the rates in effect at the time the NGPA was enacted. The Commission has likewise rejected contentions that adopting the post-1974 rate for flowing gas amounts to *de facto* deregulation of old gas. The Commission's reasoning on these issues is set forth in the discussion in section IV. A. *supra* and need not be repeated here. The principal issues raised by the rehearing applicants with respect to the level of the new ceiling price for old gas are (1) whether the Commission may properly base its determination of the just and reasonable rate for old gas on replacement costs, (2) whether the Commission's decision to do so is supported by the record, and (3) whether the post-1974 rate is representative of current replacement costs.

In Order No. 451, the Commission reviewed applicable Commission orders and court decisions pertinent to the establishment of just and reasonable producer rates under the NGA. (51 Fed. Reg. 22,185-86). The Commission noted that a vintaged rate structure was adopted with approval of the Supreme Court in the original *Permian Basin Area Rate Proceeding*, Opinion No. 468, 34 FPC

[85] Natural Gas Pipeline Company of America and United Gas Pipe Line Company (Natural and United) at 79; Peoples Gas *et al.* at 23; Southern Natural at 8; Minnesota DPS at 5.

159 (1965), that the Commission moved toward the establishment of uniform producer rates based on replacement costs in the first nationwide rate proceeding, Opinion No. 699-H, also with judicial approval, *Shell Oil*, *supra*, and that the Commission subsequently reinstated vintaging with court approval in the second national rate proceeding, Opinion No. 770, 56 FPC 509 (1976). The Commission concluded that the issues of replacement costs versus historical costs as well as vintage-based rates versus uniform rates are matters within the Commission's reasonably exercised discretion. 51 Fed. Reg. 22,186. The Commission has carefully considered the arguments presented by the rehearing applicants and concludes that they do not provide any basis for modifying the conclusions reached by the Commission in Order No. 451 concerning the Commission's authority to eliminate vintaging through the establishment of a uniform ceiling price for old gas based on replacement costs.

The reliance by numerous parties on the *City of Detroit* case in support of the proposition that gas producer rates must be based either in whole or in part on historical or original costs is misplaced. *City of Detroit* involved a pipeline rate proceeding in which the FPC authorized the pipeline to charge the so-called "field price" or "commodity value" for its own gas production. In setting aside this part of the FPC's order, the Court stated as follows (230 F.2d at 818-19) (emphasis added):

> "when we refer to an 'increase' we mean an increase in the rates above those which would result from use of the *conventional rate base method*. For, though we hold that method not to be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. It has been repeatedly used by the Commission and repeatedly approved by the courts, as a means of arriving at lawful just and reasonable rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognized meaning."

It has long ben recognized that the rate standards set forth in the *City of Detroit* are not directly or specifically applicable to the establishment of gas producer rates. In reviewing the FPC's Opinion No. 586 establishing the producer rates for the Hugoton-Anadarko area, the United States Court of Appeals for the Ninth Circuit stated, with reference to *City of Detroit*, that "that case involved a single pipeline company cost-of-service problem. The application of that decision to a review, as in the case before us, of a producer-area rate opinion and order is questionable to say the least." [56] The Commission likewise rejects the assertions of the rehearing applicants that the old gas ceiling price adopted in Order No. 451 violates standards for just and reasonable rates set forth in *Farmers Union*. In Opinion No. 154 (the *Williams* proceeding), which was the subject of the *Farmers Union* decision, the Commission proposed to adopt certain unconventional ratemaking methods for the purpose of determining rates for oil pipelines. These methods were adopted for a number of reasons including the Commission's interpretation of the legislative history of the Lodge Amendment to the Hepburn Act adopted by Congress in 1906.[57] The Commission acknowledged that

[56] In re Hugoton-Anadarko Area Rate Case, 466 F.2d 974, 989 (9th Cir. 1972). The court went on to cite the Supreme Court's decision in Wisconsin v. FPC, 373 U.S. 294 (1963), concerning the view expressed in *City of Detroit* that cost of service must be used "at least as a point of departure." The Supreme Court there stated that "whatever the court may have meant in that context, it is clear that it did not have before it any question relating to the area rate method." 373 U.S. at 310, n.16.

[57] *See Williams Pipe Line Company*, 21 FERC ¶ 61,260 at 61,582, n.78 and n.124 (1982).

the methods adopted in Opinion No. 154 result in rates substantially in excess not only of those derived through application of traditional cost-of-service methodologies but also of those estimated by the Commission to be normally obtainable through the operation of market forces. The court in *Farmers Union* rejected the cost methodologies proposed by the Commission, finding that the Commission's rejection of original cost rate-making lacked both evidentiary support and "economic common sense," 734 F.2d at 1515. The court held that oil pipeline rates must be set within the zone of reasonableness and that "presumed market forces may not comprise the principal regulatory constraint," *id.* at 1530.

We believe that due to the substantial differences in regulatory context, *Farmers Union* is no more applicable to gas producer regulation than *City of Detroit*. More importantly, there is no parallel between the methods adopted in *Williams* and those adopted in Order No. 451. The rate adopted in Order No. 451 is in no way designed merely to restrain "gross overreaching" or solely as a protection against "egregious exploitation and gross abuse," *id.* at 1502. Order No. 451 establishes a cost-based rate within the zone of reasonableness established by reference to prior FPC and court approved ratemaking principles and is supported by sound economic and regulatory policy.

The Commission also rejects the arguments of the rehearing applicants that Order No. 451 violates *City of Detroit* and *Farmers Union* not only for failure to adopt an original-cost ratemaking methodology but also for its alleged reliance on market forces to establish the rates actually charged. The establishment of a ceiling price based on replacement costs which, under existing market conditions, is in excess of prevailing market prices does not constitute an abdication of the Commission's regulatory responsibility in favor of market pricing. Any such argument ignores the very real limitation represented by

the ceiling price. The rate actually charged, while possibly below replacement cost, cannot exceed that level. Contracting parties have always been and continue to be free to negotiate prices up to but not in excess of applicable ceiling prices. Under the *Mobile-Sierra* doctrine, negotiated, below-ceiling prices are the lawful just and reasonable rates. There is no reason to assume that sales should uniformly be made at the ceiling price. The fact that particular sales can and undoubtedly will be made at prices lower than the ceiling price in no way supports the suggestion that the ceiling price is without regulatory force or effect.

In Order No. 451, the Commission relied on the FPC's first national rate proceeding, Opinion No. 699-H, as support for the pricing of old gas based on replacement cost. The Commission also relied on FPC Opinion No. 749 as supporting the Commission's discretion to consider replacement costs in setting just and reasonable rates for old flowing gas. Several applicants argue that these interpretations are erroneous, that the FPC never totally eliminated vintaging or established a single price for all NGA regulated gas, and that there is thus no valid precedent for the Commission's adoption of the post-1974 rate for all flowing gas.[58]

It will be helpful in considering the arguments of the rehearing applicants briefly to review the FPC's decisions in the national producer rate proceedings conducted prior to enactment of the NGPA. In Opinion No. 699-H, the FPC established a just and reasonable rate of 50 cents per Mcf for 1973-74 biennium gas, with annual escalations of one cent per Mcf. The Commission also ruled that the 1973-74 biennium gas would be entitled to be priced at the rate established for each succeeding period. 52 FPC at 1636. The FPC in Opinion No. 699-H also extended its policy originally adopted in Opin-

[58] INGAA at 6-7; UDC at 23-27; Florida Cities at 13-16; Laclede at 9-12.

ion No. 639 of eliminating vintaging through the vehicle of allowing replacement contracts (contracts which replace expired or expiring contracts) to receive the new gas price. 52 FPC at 1631-32. The agreement of the purhcaser to pay the higher rate was required, *id.* The FPC acknowledged that its decisions in Opinion No. 699-B would lead over an extended period of time to a uniform rate for all gas sold in interstate commerce. In support of its policy, the FPC stated as follows (52 FPC at 1637):

> This uniform price will constitute a recognition of the fact that gas is a consumable, irreplaceable commodity and not a service which can be renewed by man. Thus, there is no rational basis for setting differing price levels based upon date of discovery, lease acquisition, contract, or well commencement or completion over an extended period of time.

In Opinion No. 749, the FPC established the national rate for gas flowing in interstate commerce prior to January 1, 1973. The FPC adopted a uniform old gas rate of 29.5 cents per Mcf based on a 1972 test year, thereby eliminating the vintage categories of old gas adopted in various prior area rate proceedings.[59] In the second national rate proceeding for new gas, the FPC adopted a full DCF cost methodology resulting in a 1975-76 biennium rate of $1.42 per Mcf. In light of the magnitude of this increase over the pre-existing new gas rate of 50 cents per Mcf, the FPC reimposed vintaging. It did provide, however, that upon contract expiration, old gas would still be entitled to the 1973-74 biennium rate of 50 cents adopted in Opinion No. 699-H.

Rehearing applicants argue that Commission reliance on Opinion No. 699-H is misplaced because (1) it did not

[59] Producers were permitted to continue to collect certain special rates and area rates which were higher than the Opinion No. 479 ceiling price. 54 FPC at 3098.

eliminate vintaging immediately but rather over time as old gas contracts expired; (2) it was based on a shortage situation and the need for infusion of capital to producers; and (3) the devintaging policy was reversed in Opinion No. 770. The Commission recognizes the differences between Opinion No. 699-H and Order No. 451 in the manner in which devintaging would be accomplished; the Commission also recognizes that the FPC's devintaging plan was discontinued in Opinion No. 770. These facts, however, do not invalidate Opinion No. 699-H as a precedent for the elimination of vintaging through establishment of a replacement-cost-based ceiling price.

First, Order No. 451, like Order No. 699-H, does not authorize producers to immediately or automatically collect the post-1974 rate. Whereas Opinion No. 699-H required producers to execute replacement contracts and thus obtain their purchasers' approval in order to obtain the new gas ceiling price, Order No. 451 requires producers to negotiate their old gas contracts with their purchasers pursuant to the good faith negotiation rule and does not require any purchaser to pay the new ceiling price without its consent. Producers may abandon sales of old gas if no price agreement is reached, but purchasers may also release higher-priced gas subject to renegotiation if no price agreement is reached. Thus, while there are differences between Opinion No. 699-H and Order No. 451, there are also fundamental similarities. In the Commission's judgment, the ratemaking policy incorporated in Order No. 451 is significantly similar, even analogous to that in Opinion No. 699-H, and the Commission therefore believes that Opinion No. 699-H may properly and reasonably be relied upon as precedent supporting the findings and conclusions adopted in Order No. 451.

The Commission also believes that the efficacy of Opinion No. 699-H as a precedent is not diminished by the later issuance by the FPC of Opinion No. 770. A review

of the pertinent cases decided by the FPC prior to enactment of the NGPA reveals clearly that the FPC was given reasonable discretion to determine whether to require or discontinue vintaging and whether to rely on historical or replacement costs, so long as its decisions were within the zone of reasonableness and supported by the record. The fact that the Commission initially instituted vintaging, later moved to abandon it, and subsequently reinstated it, all with judicial approval, supports this view.

The Commission also rejects arguments that Order No. 451 misinterprets or misapplies the decision in *Tenneco, supra.* In Order No. 451, the Commission relied on *Tenneco* for the proposition that the Commission has discretion to select between historical or replacement cost in establishing just and reasonable rates for old gas. The Commission relied on the court's statement that "Insofar as theories of regulation are concerned, the choice between actual and replacement cost is for the Commission to make, subject to the sole requirement that the end result be within the 'zone of reasonableness'" 571 F.2d at 840. Parties objecting to the Commission's reliance on *Tenneco* point out that the court also noted in its opinion that under the Constitution as well as the NGA, producers are only entitled to a fair return on their "actual costs"[60] and that the FPC's Opinion No.

[60] The pertinent portion of the Court's decision reads as follows (571 F.2d at 840):

> The "zone of reasonableness" is wide. The producers, under the Constitution as well as the [NGA], are at bottom, only entitled to a fair return on their actual costs, i.e., a rate which, if anticipated at the time their wells were dug would be sufficient to "maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they assumed." *Permian,* 390 U.S. at 792, 88 S.Ct. at 1873. Subsequent increases in operating costs would be taken into consideration, but replacement value would not.

749, which was the subject of the *Tenneco* decision, did not actually adopt replacement cost pricing for old gas.

The Commission believes that *Tenneco,* in affirming the FPC's old gas pricing policy adopted in Order No. 749, is relevant to the issue of replacement cost pricing. Although the FPC did not in Opinion No. 749 adopt a flowing gas ceiling price based solely on replacement costs, it did eliminate vintaging of old gas through the adoption of a uniform ceiling price based on then-current (1972) exploration and development costs rather than purely historical costs. 54 FPC at 3105. As the court in *Tenneco* observed (571 F.2d at 837-38):

> In calculating costs, the Commission made a number of judgments challenged here. It chose to measure exploration and development costs by using a 1972 test year, even though many of the wells from which the gas comes were developed at a lower cost years earlier.

The Commission does not concede that its findings in Order No. 451 are in any way based on a misinterpretation or distortion of the holding in *Tenneco.* Although Opinion No. 749 and the related decision in *Tenneco* are not as directly relevant to the replacement cost issue as Opinion No. 699-H, we believe they support the Commission's discretion to eliminate vintaging of old gas and to choose between replacement and historical cost in setting just and reasonable rates for old gas. Clearly *Tenneco* does not support the claim by rehearing applicants that old gas ceiling prices must remain vintaged as well as based on historical costs. For the reasons discussed above, the Commission reaffirms its determination in Order No. 451 that it is permissable for the Commission to establish a uniform ceiling price for old gas based on replacement costs.

The next principal issue to be considered is whether the record in this proceeding supports the Commission's decision in Order No. 451 to base the ceiling price for

old gas on replacement costs. A number of parties argue that the FPC's decision in Opinion No. 699-H was justified on the basis of the then-existing natural gas shortage in the interstate market and the need for "vastly expanded exploration and development programs to meet future demand. . . ." 52 FPC at 1613.[61] It is argued that the NGPA, which eliminated the interstate-intrastate regulatory dichotomy and incorporated incentive prices for new gas and special rates to support continuing or incremental production from old wells, has resulted in a gas surplus and that there is therefore no emergency need to increase old gas prices as a means of financing exploration for increased supplies. New York Public Service Commission, for example, argues that the use of replacemnet cost as a basis for old gas ceiling prices would be lawful only if the Commission could find that the resulting additional producer revenues are necessary to provide investment funds needed for adequate exploration and development of new supplies and that such additional revenues will actually be used for that purpose. According to New York, "the Commission has not made any such finding and none would be possible on the basis of the record before it." [62]

The Commission agrees that the FPC's decision in Opinion No. 699-H was based on the gas shortage which then existed and the need to finance a greatly increased program of exploration and development of additional supplies; the Commission likewise agrees that the present market is characterized by oversupply in relation to demand. It follows that the rationale relied upon by

[61] The FPC in Opinion No. 699-H stated that "the magnitude of the drilling effort that will be required to elicit the supply of gas necessary to fulfill reasonable future demands calls for massive capital commitments." 52 FPC at 1638 (footnote omitted). This finding was accepted by the reviewing court in Shell Oil Co. v. FPC, 520 F.2d at 1077 (5th Cir. 1975).

[62] N.Y. PSC at 8.

the Commission in Opinion No. 699-H is not applicable in light of present industry conditions. However, the Commission disagrees with the suggestion that replacement cost pricing of old gas can be justified solely and exclusively on the grounds specified in Opinion No. 699-H. We believe that replacement cost pricing is supported by the record in this proceeding, albeit for reasons different from those set forth in Opinion No. 699-H.

In Order No. 451, the Commission reviewed the record and concluded that the pre-existing old gas price structure was unjust and unreasonable (51 Fed. Reg. 22,179-83). The Commission determined that the old gas price structure was the principal cause of distortion in the natural gas market, prevented fair competition, failed to accurately reflect the cost and market value of the many categories of old gas, and resulted in inefficient production and the potential loss of trillions of cubic feet of old gas reserves. The Commission also noted that the elimination of vintaging had been contemplated since the inception of formal producer price regulation commencing with the FPC's original Statement of General Policy No. 61-1 in 1960 (51 Fed. Reg. 22,182). The Commission further noted (51 Fed. Reg. 22,182-83) that the courts reviewing its orders had observed that the vintage-based pricing system was anomalous, *Placid Oil Co. v. FPC*, 483 F.2d 880 (5th Cir. 1973), and resulted in a "gargantuan inequity." *Tenneco, supra.* (51 Fed. Reg. at 22,185). The Commission further found that under the partially decontrolled pricing system adopted by the NGPA, it was inevitable that where old gas prices were frozen at levels equal to only a fraction of replacement cost, prices of unregulated supplies would become disproportionately high to enable producers to realize overall prices over the long term at least equal to replacement cost (51 Fed. Reg. 22,186). The Commission found that this is what occurred following enactment of the NGPA, that the resulting price distortions between new and old gas are a prime cause of dysfunction in today's nat-

ural gas market, and that further exacerbation of the distortion in natural gas prices is likely to occur at such time as the current surplus is eliminated and supply and demand come into balance. (51 Fed. Reg. 22,187).

The Commission has reviewed the arguments of the rehearing applicants and finds they provide no basis for modifying the conclusions reached in Order No. 451. The Commission has reviewed and reaffirms its findings in Order No. 451 that the existing old gas price structure is unjust and unreasonable and should be replaced by a uniform old gas ceiling price based on replacement cost. The Commission believes the issues related to both the old and new price structure for old gas were fully considered in Order No. 451 and that the determinations made were fully justified for the reasons stated.

The Commission is convinced that it is essential in selecting a proper cost basis for old gas ceiling prices to recognize the fundamental differences between the exploration for, and production and sale of natural gas and the providing of traditional utility services. As the Commission has previously observed, natural gas is a "consumable, irreplaceable commodity and not a service which can be renewed by man." Opinion No. 699-H, 52 FPC at 1637. An electric generating plant can be constructed which may last for decades and produce electricity virtually on demand and in the amounts desired. Similarly, a pipeline can be constructed for use over an extended period through which gas can be transported on demand and in the quantities desired. The same is true for other utility services such as transportation or telephone services. By contrast, natural gas is a non-renewable energy resource. The total supply of gas, while not precisely known, is finite, and the ultimate stock provided by nature cannot be replenished. The compelling need to replace natural gas consumed is the driving force behind the entire natural gas industry. It is reasonable

that consumers of gas should pay prices up to but not in excess of the cost of replacing the volumes which they consume. Gas prices that are equal to only a fraction of replacement cost encourage the rapid, inefficient consumption of this non-renewable resource.

The Commission firmly believes that it is inconsistent with logic, common sense and economic reality to have multiple, binding ceiling prices for a fungible commodity, whether it be bushels of wheat, bars of gold, bales of cotton, barrels of oil or Btus of natural gas. *Placid Oil, supra.* Of course, uniform pricing of natural gas is not possible absent total deregulation. However, the adoption of a uniform ceiling price reflecting replacement costs constitutes a significant step in the right direction and the most the Commission can do within the limits of its statutory authority. In Opinion No. 770, the FPC held that reimposition of vintaging was necessary to "preclude the exaction of excessive and unjustifiable economic rent from flowing gas." 56 FPC at 521 (1976). The Commission rejects this finding in Opinion No. 770 to the extent it implies that in workably competitive wellhead markets any economic rent realized by producers for the sale of flowing gas could be judged to be "excessive and unjustifiable." The Commission is finding in this rulemaking that pricing old gas at its replacement cost over the long-term will assure that economic rents exacted by all producers for all gas will be most responsive to competitive conditions in wellhead markets as mandated by the NGPA. If competitive conditions in energy markets permit producers a higher return in exploration and development than in other endeavors, then such investments will be made. If energy markets do not permit the producer a higher return on exploration and development than on other investments, then the economic rents may not be reinvested in additional drilling. In both cases, the economic rents are allocated in a market-responsive manner consistent with the competitive conditions mandated by the NGPA. For this rea-

son, the Commission finds that this rule will not result in the "exaction of excessive and unjustifiable economic rent from flowing gas." Furthermore, in Order No. 451 the Commission determined that some old gas prices would increase while other old gas prices would decrease under the good faith negotiation provisions. The Commission also found that the increased ceiling price for pre-1974 gas would allow some old gas wells to operate to a lower pressure and level of production, thereby permitting the wells to produce a greater percentage of resources-in-place. Without this price incentive the Commission estimated that a significant amount of old gas would not be produced. For these reasons, the Commission concludes that the record as well as economic common sense and sound regulatory policy dictate that the ceiling price of old gas be based on replacement rather than historical costs.

In considering the means by which to implement replacement cost pricing, the Commission reaffirms its support for the analysis submitted by DOJ. DOJ argues persuasively that in a competitive industry, market forces drive prices toward the producer's marginal cost. 51 Fed. Reg. at 22,186. In the terminology of producer regulation, this means replacement cost. Thus in a competitive industry, market prices will reflect replacement cost and regulation is theoretically unnecessary.

There can be no reasonable doubt that the natural gas producing industry is workably competitive. The Commission so found in Order No. 451, citing Congress' implicit finding of competitiveness in enacting the NGPA, judicial acknowledgments of such Congressional intent, and the declining trend in gas prices since 1984 resulting from conditions of oversupply. (51 Fed. Reg. at 22,195-96). Other available evidence supports the finding of a competitive natural gas market among sellers. EIA, for example, prepared a comprehensive study of the concentration of interstate sellers in some nine regional producing areas and 26 production sub-areas.[63] The results of this study indicate a low level of seller concentration in every market except Alaska and similarly low levels of seller concentration in 23 of 26 producing areas.[64] These findings are consistent with and support conclusions reached in earlier studies.[65]

Despite the Commission's finding of competition among sellers of natural gas and the resulting absence of any real need for wellhead price controls, the Commission nevertheless, out of necessity as well as an abundance of caution, adopts the post-1974 ceiling price recommended by DOE. The basis for Commission approval of this ceiling price is replacement cost. The Commission recognizes that there is no perfect formula for calculating replacement cost. Because of the characteristics of the natural gas producing industry, including high risk, price variability, joint products, and fluctuating costs, there can be no one price which is precisely representative of replacement cost. The Commission believes, however, that the DCF model adopted by the FPC in Opinion No. 770 is the most reasonable method available for purposes of estimating current replacement costs.

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[63] Richard P. O'Neill, James B. Tobin, and Henry Clarius, "Pipeline Mergers and Their Potential Impact on Natural Gas Markets", *Natural Gas Monthly*, Energy Information Administration, February 1986.

[64] *Ibid.* at Tables F3 and F4. Data for the remaining 3 areas was inadequate or incomplete. Most sales in these areas were in intrastate commerce or in certain instances only a few sales occurred. These areas together accounted for less than 1 percent of total interstate sales in 1984.

[65] Joseph P. Mulholland, *The Economic Structure and Behavior in the Natural Gas Production Industry*, Federal Trade Commission, February 1979. Ronald R. Braeutigam, "The Deregulation of Natural Gas", in *Case Studies in Regulation: Revolution and Reform*, ed. by Leonard W. Weiss and Michael W. Klass, Little, Brown and Co., (Boston: 1981).

As outlined in detail in Order No. 451 (51 Fed. Reg. 22,185-88), the post-1974 rate had its origin in Opinion No. 770, in which the FPC adopted a rate for post-1974 gas of $1.42 per Mcf. The rate was increased by one cent per quarter until enactment of the NGPA and thereafter adjusted according to the NGPA's monthly inflation adjustment. The Commission concluded that the DCP cost methodology adopted in Order No. 770 remained a reasonable method of calculating the replacement cost of gas. The Commission also held that in light of the adjustment-for-inflation feature of the NGPA, it was reasonable to assume the current post-1974 ceiling price remained representative of replacement costs absent a showing that the inflation adjustment had either overstated or understated changes in the cost of finding and producing gas since enactment of the NGPA. The Commission also considered and found reasonable the replacement cost study submitted by Indicated Producers demonstrating a 1985 replacement cost of $2.77 per MMBtu. The Producers' study represents an updated application of the Opinion No. 770 methodology incorporating recent data concerning productivity, reserve additions, income tax liability, drilling costs, and industry capital structure.[88]

Certain rehearing applicants argue that the Commission has failed adequately to demonstrate that the post-1974 rate is representative of current replacement costs. Several applicants argue that the Commission's assumption, based on the NGPA monthly adjustment factor, that the post-1974 rate remains representative is without adequate support, and that such an assumption is belied by the fact that drilling costs have actually declined. Several

[88] The Commission also notes a recent study of oil and gas replacement costs presented to the Cost Study Committee of the Independent Petroleum Association of America, finding a current replacement cost of $4.00 per Mcf for gas. *See* "Analyst Suggests True Oil Replacement Costs Cause Heavy Financial Pressure," *The Oil Daily* (November 20, 1986), p. 2.

applicants also question the Commission's reliance on the Indicated Producers' replacement cost study.

The Commission agrees that the NGPA's inflation adjustment factor, in and of itself, does not assure that the original Opinion No. 770 rate will remain representative of replacement cost. The Commission agrees therefore that it would be improper to rely solely on the inflation factor to justify the reasonableness of the current post-1974 rate. However, the Commission has not relied solely on the NGPA's adjustment factor, the Commission also carefully reviewed the updated Opinion No. 770 study submitted by Indicated Producers and found it to be reasonable and to confirm the reasonableness of the post-1974 rate proposed by DOE. Rehearing applicants' objections to the Commission's reliance on the Producers' study are without merit. The Producers' study was submitted as part of the initial comments of Indicated Producers. All parties had an opportunity to respond to all of the issues raised in the initial comments including the Producers' replacement cost study. No party has presented any facts, evidence, or information whatsoever, either in their reply comments or on rehearing, challenging the validity of the Producers' study as representing a valid estimate of current replacement costs based on the Opinion No. 770 DCF model.

The Commission has again reviewed the study and finds that it represents an accurate and reasonable application of the Opinion No. 770 methodology. The Commission therefore properly adopts this study as representing a reasonable measure of the current replacement cost of natural gas, and finds its underlying assumptions to be reasonable. The Commission specifically approves as reasonable the Producers' productivity factor of 145 Mcf per successful gas well foot drilled. The Commission likewise adopts as reasonable the Producers' drilling costs of $70.10 per foot for successful wells and $59.67 per foot for dry holes. In estimating 1985 drilling costs, Produc-

ers' trended actual 1984 costs downward based on data reported by EIA and API.[67] Successful well costs were adjusted downward 21 percent from $88.73 per foot (actual) in 1984 to $70.10 (estimated) in 1985; dry hole costs were adjusted downward 10 percent from $66.52 (actual) in 1984) to $59.67 (estimated) in 1985.[68] However, if the index-based adjustment procedure actually utilized by the FPC in Opinion No. 770 (56 FPC at 543) were applied to actual 1984 drilling costs the result would be estimated 1985 drilling costs of $83.94 per foot for successful wells and $62.93 per foot for dry holes.[69] Producers' 1985 drilling cost estimates may thus fairly be characterized as conservative.

Several applicants allege procedural flaws in the Commission's consideration of replacement costs.[70] They argue that there was insufficient notice of the Commission's intent to rely on the Opinion No. 770 DCF cost analysis in establishing the ceiling price for old gas and that the Commission should reopen the record and prepare its own cost study which would then be subject to further comment by all interested persons.[71]

The issue of replacement cost pricing has been raised throughout these proceedings. DOE's proposal was based in part on the fact that the old gas price structure failed to assign a reasonable share of replacement costs to purchasers of old gas. 50 Fed. Reg. at 48,541 (November 29, 1985). DOE and Indicated Producers, among others, specifically relied in their initial comments on the concept of replacement cost to support DOE's old gas pricing proposal,[72] and the issue was fully discussed in the parties' reply comments. In fact, the Commission requested reply comments for the very purpose of providing an opportunity to respond to each issue. It is noteworthy that the ceiling price proposed by DOE and adopted in Order No. 451 is a replacement cost price; the source of the post-1974 rate in Opinion No. 770 is a matter of common knowledge. The argument that interested persons did not have full opportunity in this proceeding to submit their views on the issue of replacement cost pricing is thus simply not credible.

The Commission also rejects the suggestion that the record in this proceeding is incomplete or inadequate without a separate 1985 replacement cost study prepared by the Commission or its staff. It is true that the Commission staff developed proposed cost models in the prior national rate proceedings. However, those proceedings involved issues concerning cost methodology as well as cost level and various parties submitted cost studies incorporating a variety of suggested methodologies.[73] Here, however, no question of methodology is involved. The Commission has found the Opinion No. 770 DCF method to be reasonable, and the only thing necessary to do is apply the Opinion No. 770 methodology. Indicated Producers did this in the DCF study included in their initial comments. The Commission has critically reviewed the study and reaffirms its prior conclusion that the Indicated Producers' study is reasonable and properly reflects application of the Opinion No. 770 principles. The Commission notes that the Tax Reform Act of 1986 was

[67] Indicated Producers' initial comments, Appendix A, Exhibit B, Schedule 3. Actual 1985 drilling costs have not yet been reported by the Joint Association Survey.

[68] *Ibid.*

[69] The current value for the adjustment index used in Opinion No. 770 is obtained from IPAA Report of the Cost Study Committee, Midyear Meeting, Nashville, Tennessee, May 1, 1986, Table 1. That index is 94.6, representing a decline of 5.4 percent from 1984. Applying this adjustment factor to actual 1984 drilling costs results in $83.94 per foot for successful wells and $62.93 per foot for dry holes.

[71] NDG at 13; APGA at 78-80.

[72] DOE at 19-22, 36-37; Indicated Producers at 31-34, 41-46, Appendices A and C.

[73] *See, e.g.*, Opinion No. 770, 56 FPC at 519.

enacted subsequent to the issuance of Order No. 451. The Tax Reform Act modified certain of the assumptions used in the Producers' DCF study, notably the federal corporate income tax rate and allowance for investment tax credits (ITC). The Tax Reform Act provides for a corporate tax rate of 34 percent (effective July 1, 1987) as compared to the 46 percent used by Producers and for elimination of ITC in contrast to the eight percent rate used by Producers. Substituting these changes in tax provisions in place of those utilized by Producers' results in a slight overall reduction in the 1985 replacement cost estimate from $2.77 to $2.71 per MMBtu.

As a further check on the reasonableness of the 1985 estimated replacement cost, the Commission has calculated replacement costs for each year 1979 through 1984 using the Opinion No. 770 DCF methodology and the Producers' application of that methodology. Actual drilling costs and actual productivity values for each year were utilized. The resulting replacement costs, which vary from $3.05 per MMBtu in 1979 to over $6.00 per MMBtu in 1982 are shown in the following table. The average replacement cost for the entire 1979-1984 period is $3.98 per MMBtu.

Year	Successful Well Cost $/foot [74]	Dry Holes $/foot [74]	Productivity Mcf/foot [75]	Replacement Cost With 4% Escalator
1979	80.54	63.21	148	$3.05
1980	94.87	72.08	130	4.07
1981	121.70	88.63	202	3.32
1982	145.96	102.62	130	6.13
1983	108.37	77.75	155	3.86
1984	88.73	66.52	143	3.44

[74] Based on actual costs and footage published in this Joint Association Survey 1979-1984.

[75] For 1979, Reserves of Crude Oil, Natural Gas Liquids, and Natural Gas in the U.S. and Canada and U.S. Productive Capacity, AGA-API-CPA. For 1980-1984, U.S. Crude Oil, Natural Gas, and Natural Gas Liquids Reserves, Annual Reports, DOE-EIA.

These results demonstrate the variability of replacement cost estimates from year to year. It may be seen, however, that the Producers' estimate of $2.77 ($2.71 adjusted for tax changes) is conservative when measured in relation to the total range of annual replacement cost values resulting from application of the Opinion No. 770 model. For the foregoing reasons, the Commission denies the requests for rehearing on the ceiling price issue and reaffirms its conclusion that the old gas ceiling price adopted in Order No. 451 is just and reasonable within the meaning of the NGA.

D. *Supply Response.*

In Order No. 451, the Commission found that eliminating vintaging will substantially increase recoverable old gas reserves through delayed abandonment of wells. The Commission reasoned that the increased ceiling prices for pre-1974 gas will allow wells to operate to a lower pressure and level of production before the net present value of future costs outstrip the net present value of future revenues, thereby permitting the wells to produce a greater percentage of reserves. The Commission reached this conclusion after a careful review of various studies in the record, including those by DOE, Indicated Producers and AGA, concerning the effect of eliminating vintaging on recoverable reserves.

Those studies generally followed a methodology first developed in an April 1983 study by the Shell Oil Company estimating the increased production from total decontrol of natural gas prices. Under that methodology, the increase in recoverable reserves in the fourteen largest gas fields in the United States is first estimated. This is done by estimating (1) the pressure at which each field would be abandoned under current prices, (2) the lower abandonment pressure of the fields under the new ceiling prices, and (3), based on these estimates and reserve data for the fields, the resulting increase in recoverable reserves. The fourteen field data is then

extrapolated to a nationwide basis to estimate the total increase in production. This is done in such a way as to account for the fact that some old gas may qualify for NGPA incentive or deregulated prices in any event and other old gas, including that subject to fixed rate clauses, may not receive an increased rate. (The fourteen field data does not take those factors into account.) The Indicated Producers' study predicted an increase in recoverable reserves from eliminating vintaging of 16 Tcf. DOE estimated an increase of 9 to 12 Tcf, with its best estimate 11 Tcf. AGA predicted an increase of approximately a third that predicted by DOE. The Commission found the DOE estimate to be the most reliable of the three. The Commission's analysis of the AGA study revealed a number of errors not made by DOE, which caused AGA to underestimate the probable supply response. Similarly, the Shell study contained errors causing an overestimate of the probable supply response.[76] The Commission, however, emphasized the uncertainty of any prediction of the exact amount of the increase, since many of the relevant variables, including future market prices, are uncertain.

Rehearing Requests. On rehearing, a number of applicants attack the Commission's finding of a substantial increase in recoverable reserves through delayed abandonment. Only AGA, however, makes a detailed critique of the Commission's reliance on the DOE study.[77] AGA contends that, in estimating the supply response from the fourteen fields, the DOE study improperly assumed prices would rise to the new ceiling price,[78] used outdated data from different time periods for reserves and abandonment pressures, and failed to account for the fact that under

[76] The errors in the AGA and Shell studies are fully discussed in Part IV. D of Order No. 451, 51 Fed. Reg. at 22,191-22,193.

[77] AGA at 10-17.

[78] *See also* Northern Natural at 29.

current law producers may in many cases collect compression costs in addition to the ceiling price. AGA also contends that the DOE study made errors in extrapolating the fourteen field data to a national level. Allegedly, the DOE study improperly included some intrastate gas in its predicted increase. It also failed to account for the fact that most of the predicted increase would occur in any event under the NGPA section 108 incentive prices for stripper wells.[79] Finally, it used 1981 national reserve figures in making the extrapolation, thus failing to account for the fact that reserves produced since 1981 are no longer available for increased production.

Other applicants for rehearing, while not addressing the specifics of the DOE and other studies, question the general conclusion that eliminating vintaging will substantially increase recoverable reserves. Several applicants state that the increased production cannot occur during a time, such as now, when there is a natural gas surplus. Others contend that, even assuming increased production of old gas and a concomitant lowering of overall prices as predicted by the Commission, the result will be a sharp decrease in new drilling and stripper well activity, causing a decrease in new production. This allegedly will offset the increased production of old gas, causing a gas shortage and higher prices. Furthermore, some applicants contend, the incremental cost of the increased production of the old gas (the increased cost of all old gas divided by the increase in recoverable reserves) will be exorbitant.

Commission Response. The Commission continues to believe that eliminating vintaging will cause a substantial increase in recoverable reserves of old gas. Furthermore, nothing raised on rehearing causes the Commission to modify its belief that DOE's study predicting an ap-

[79] APGA at 34 contends that the increased supply response could also occur pursuant to special relief.

proximate 11 Tcf increase is the most convincing analysis in the record of that increase.

In its rehearing request, AGA again contends that DOE made a number of errors in estimating the increase in recoverable reserves in the fourteen field study. Several of AGA's allegations of error are incorrect, and AGA has not shown that the other alleged errors affect the validity of DOE's prediction of a substantial increase in reserves in the fourteen fields. First, AGA contends that DOE incorrectly assumed that old gas prices would rise to the new alternative ceiling price (now $2.61) rather than to the current market price alleged to be approximately $1.90.[80] AGA alleges that if DOE had used $1.90 its prediction of increased production would have been cut by one-third. The Commission rejects this contention.

For purposes of predicting the increase in recoverable old gas reserves, estimated average prices over the next twenty to forty years should be used, since old gas is not expected to be exhausted before then. While future gas prices cannot be projected with certainty, it is unlikely that current depressed prices will continue indefinitely. The current low price of gas has resulted in a dramatic drop in drilling activity.[81] Therefore, it appears inevitable that the current surplus deliverability will disappear and that as a result prices will increase in order to maintain an equilibrium between supply and demand. For these reasons, the Commission believes that DOE's projection that gas prices will reach the new ceiling price by 1990 is reasonable. This price thus seems a reasonable basis for projecting the supply response from eliminating vintaging, since the majority of abandonment decisions will be made after 1990. In addition, even pre-1990 abandonment decisions will take into account expected higher future prices since producers abandon wells

[80] *See also* Northern Natural at 29 and Florida Cities at 21.

[81] Northern Natural at 29-30.

only when the net present value of total predicted future costs exceed the net present value of total predicted future revenues.[82]

Second, AGA contends that much of the increased production claimed from the fourteen fields as a result of Order No. 451 would occur in any event because of the availability of the compression allowance under NGPA section 110.[83] Section 271.1104(d)(iv) of the Commission's regulations allows a producer to collect such allowances[84] in addition to the maximum lawful price, if the producer's contract expressly authorizes collection of compression costs and if the compression facility was installed after enactment of the NGPA.[85] AGA argues, in effect, that when DOE determined the pressure at which each of the fourteen fields would be abandoned at current prices, it assumed that current prices equal the existing ceiling prices, failing to take into account producers' ability to collect more than the current ceiling price through a compression allowance. In view of the au-

[82] If, despite the facts stated above, prices fail to rise to the new ceiling price (perhaps because of competition from alternative fuels) then it is likely that recoverable reserves will not increase as much as projected by DOE. However, any market force sufficiently strong to keep old gas prices significantly below the new ceiling price indefinitely into the future in the face of the current collapse in drilling activity is likely to be strong enough to keep overall prices from rising. In addition, the increased production of old gas (although less than projected by DOE) would be all the more important, since at such low prices very little new gas could be expected to be found and produced.

[83] *See also* KP&L *et al.* at 25-26.

[84] The allowance is 6¢ per stage of compression not to exceed 18¢, plus compensation for the cost of fuel or power to drive the compressor.

[85] *But see* Texas Eastern Transmission Corp. v. FERC, 769 F.2d 1053 (5th Cir. 1985, *cert. denied*, 106 S. Ct. 1967 (1986) (Permits recovery of fuel and power costs to operate compressors constructed prior to the NGPA).

thorization for producers to collect those allowances, this assumption allegedly was improper and may have resulted in a substantial overestimate of the overall supply response. AGA contends that EIA's May 1986 *Analysis of DOE's Notice of Proposed Rulemaking, Ceiling Prices: Old Gas Pricing Structure* (EIA Study) (at 22-25) demonstrates that where pipelines pay compression costs, producers are able to produce 46 percent of the gas which DOE claims will be produced as a result of the new ceiling price.

It is unclear whether the DOE study accurately accounts for compression allowances in calculating current abandonment pressures for the fourteen fields. However, even if it does not, the Commission does not believe that such an omission would significantly affect the reliability of the DOE Study. The Commission's regulations authorize producers to collect compression costs only when expressly authorized to do so by contract. The EIA study relied on by AGA indicates that producers actually collect compression costs with respect to only 28 percent of sections 104 and 106 gas subject to compression. Thus, even assuming that pipelines' payment of compression costs does bring about 46 percent of the production increase claimed by DOE, that 46 percent increase would occur in only 28 percent of the cases under present contractual arrangements. The alleged error in the DOE study, therefore, could at most cause an overestimate of increased production by 12.4 percent (28 percent of 46 percent equals 12.4 percent) assuming pipelines do not agree to bear a significantly greater percentage of compression costs than they now do.

Furthermore, the Commission does not believe that, even in those cases where pipelines assume compression costs, the supply response from the rule would be reduced by 46 percent. While the producer could charge the compression allowance in addition to the existing ceiling price, it could also charge the compression allowance in

addition to the new ceiling price.[86] Thus, to the extent DOE ignored compression allowances, it not only failed to take into account any additional production that the allowance permits under existing law, it also failed to take into account the additional production that the allowance would permit under the new price ceiling. The two factors largely offset one another.[87]

Finally, the Commission observes that while the EIA study predicts a supply response of 8.4 Tcf assuming all compression costs are borne by pipelines but 15.9 Tcf if they are borne by producers, EIA's overall predicted production increase is 11.7 Tcf, based on the fact pipelines assume compression costs only 28 percent of the time. That figure agrees very well with the DOE study's predicted 11 Tcf increase.

The third error alleged by AGA in DOE's calculation of increased production from the fourteen fields is DOE's use of unreliable reserve and pressure data. AGA asserts that DOE improperly used reserve data for each of the fields published in 1970; that data allegedly is so outdated, having been collected for example at a time when the average wellhead price was only 17¢, as no longer to be reliable. AGA also reiterates its earlier criticism of DOE for estimating pressures in each of the fourteen fields based on field depth and other factors rather than relying on actual measurements of field pressure. AGA's assertion that DOE used 1970 reserve figures is inaccurate. It is apparent from DOE's reply comments that, unlike the 1983 Shell study and the Indicated Producers'

[86] Based on the discussion above at page 67, the Commission believes that the market will generally permit such collection over the 20 to 40 year period of the predicted supply response.

[87] It should also be noted that the compression allowance is relatively small compared with price increases permitted by this rule. The allowance is only 6¢ per compression stage up to a maximum of 18¢ plus fuel costs. This compares to an increase in the ceiling price for pre-1973 gas, for example, from 52¢ to $2.57.

study, DOE used figures for reserves from a 1980 AGA study presented to Congress's Office of Technology Assessment (OTA) for its consideration in preparing a February 1984 report entitled *Effects of Decontrol on Old Gas Recovery.*[88]

More importantly, AGA has not shown that any inaccuracies in DOE's reserve and pressure data are significant enough to affect the essential conclusion that the increased production from the fourteen fields will be substantial. In its comments, AGA submitted a study using updated reserve data, actual field pressures, and an assumed $1.90 market price for old gas to estimate the increased production from the fourteen fields. That study shows increased production of 2.3 Tcf, nearly half DOE's prediction of 5.7 Tcf. Such an increase, as the Commission observed in Order No. 451, would still be significant. Furthermore, the AGA study contains errors leading it to *underestimate* the probable increased production in the fourteen fields. As already discussed above, the AGA study improperly assumed a market price for old gas of $1.90 rather than the new ceiling price. In addition, as fully discussed in Order No. 451, the AGA study used reserve and pressure data from different years causing a further underestimate of increased production in the fourteen fields.[89] In its rehearing request, AGA does not contest Order No. 451's criticism of its study on this basis.

The Commission has now considered all contentions raised on rehearing concerning increased production from the fourteen fields. None alter the Commission's belief that elimination of vintaging will cause a substantial increase in recoverable reserves in the fourteen fields.

Once increased production in the fourteen fields has been estimated there remains the task of extrapolating

[88] DOE reply comments at 4.

[89] *See* 51 Fed. Reg. at 22,192.

the fourteen field results to a national level and accounting for production that would occur in any event under existing incentives. DOE accomplished this task by a three step procedure. First, it extrapolated the fourteen field results to a national level by multiplying those results by the ratio of ultimate national reserves to ultimate reserves in the fourteen fields.[90] Next, DOE reduced its estimate of national increased production by four percent, in order to account for production which would have occurred in any event under existing section 108 incentive prices for stripper wells. Finally, in order to adjust for the 1983 Shell study's failure to account for other gas that would receive adequate prices to stimulate full economic production under current regulations, DOE scaled down its estimate of increased production by the ratio of DOE's estimate of the total reserves responsive to eliminating vintaging (66 Tcf) to Shell's (115 Tcf) or about 57 percent. Neither AGA nor other rehearing applicants attack the adjustment made in the first step of DOE's extrapolation procedure. However, they do attack the adjustments made in the second and third steps.

First, AGA claims that the stripper well adjustment is too small. It notes that 40 percent of all producing wells are stripper wells and that to date over 100,000 wells have qualified as stripper wells. AGA contends that these facts suggest that most section 104 and 106 wells will eventually qualify as stripper wells, thus providing the production response anticipated under Order No. 451 without collapsing old gas vintages.

AGA's contentions on this point are not persuasive. While the Commission can confirm that as of March 1986, over 100,000 wells have qualified for stripper well pricing under NGPA section 108 nationwide, over 50 percent of

[90] *See* 51 Fed. Reg. at 22,193 for a discussion of why use of the ratio of ultimate national reserves to ultimate reserves in the fourteen fields is appropriate for this purpose.

all such wells are located in a limited geographic area, in the Appalachian region of the country.[91] Moreover, the average daily production from these wells is extremely low, consertively estimated in most cases at fifteen Mcf per day or less.[92]

Thus, stripper wells are not for the most part located in areas where substantial reserves of old gas are located. The OTA study confirms that an unknown percentage of stripper applications are new, low production wells, and are not examples of how the stripper incentive has prolonged well lives.[93] In West Virginia, which accounts for almost one-quarter of all stripper wells, for example, producer filings since 1984 are generally made for WGPA section 103, with a later filing for a section 108 determination for the same well approximately three months later.[94] Thus, these wells are not

[91] Data on the number and location of NGPA section 108 stripper wells is derived from Forms 121 filed with the Commission. Of the over 100,000 stripper wells nationwide, about 11,000 are located in Ohio, 1,700 in New York, 26,000 in West Virginia, 13,000 in Pennsylvania, and 3,500 in Kentucky, for a total of 56,000 in the Appalachian region, or over 50 percent of all stripper wells.

[92] In 1983, the average daily per well production from a gas well in the States of Ohio, New York, West Virginia, Pennsylvania, and Kentucky was 15 Mcf, 19 Mcf, 14 Mcf, 13 Mcf, and 15 Mcf, respectively. Since stripper wells comprise approximately 62 percent of the total number of producing gas wells in these states, and the average per day per well production figures include other wells, the per day production from stripper wells is probably even lower. *See* Interstate Oil Compace Commision, The Oil and Gas Compact Bulletin, Vol. XLIII, No. 2 (Dec. 1984) at S-2 (United States 1983 Production of Oil and Gas by States).

[93] Office of Technology Assessment Staff Memorandum on the Effects of Decontrol on Old Gas Recovery, prepared by the Energy and Materials Program (Feb. 1984) at 50.

[94] Prior to 1984, before gas prices became extremely depressed, producers would more commonly file for NGPA sections 102 and 107 determinations, as well as section 103, and then later file for a section 108 determination for the same well after completing a 90-

old gas wells whose life has been prolonged by obtaining stripper well status, but instead are new, low-production wells. Even though we do not know precisely how many stripper wells are new wells nationwide, under current market conditions this is more likely to be the case than not.

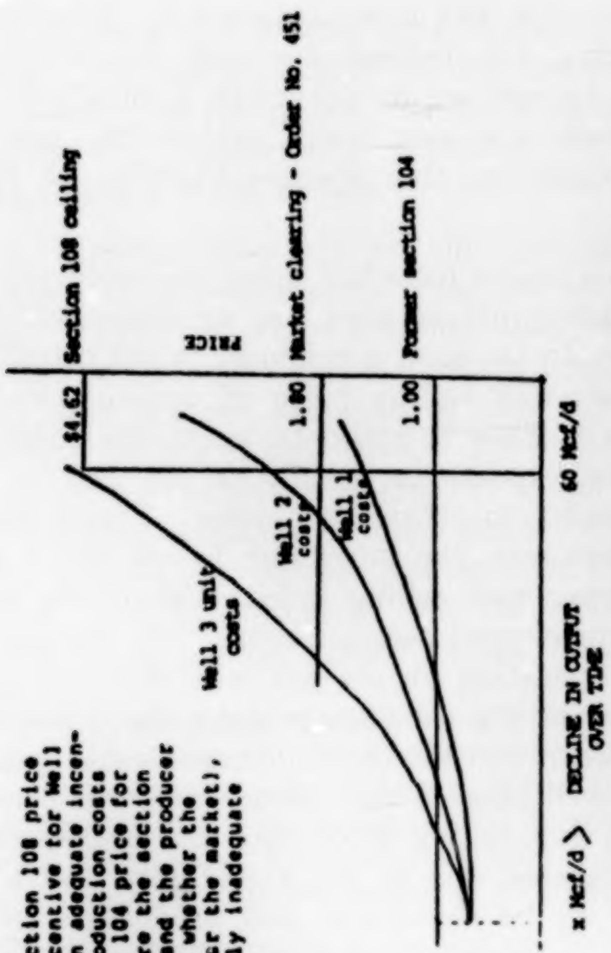
AGA's contention might have had more relevance prior to 1984 when market prices were not as depressed as they are currently. In the past, a producer might actually obtain the stripper well ceiling price of approximately $4.00 per MMBtu.[95] Thus it would be worth the administrative effort and expense to qualify an old well as a stripper well in order to obtain that price. Under current conditions, however, the purchaser is not likely to pay the full stripper well ceiling price, even if the old well obtains a stripper well determination.[96] In the past, when the cost of operating an old gas well exceeded the revenues generated at the old vintage price the operator may have continued production until the well could qualify as a stripper well because the operator knew it could obtain the section 108 ceiling price once the well qualified. In today's market this is not a certainty and the well will more likely be abandoned and production lost. (The diagram at the margin graphically illustrates this syndrome.) Plainly, the market, including consumers, producers, pipelines, distribution companies, and industrial end-users are better off with less new gas and more old gas that is now being abandoned if this additional

day production period in order to prove that the well did not exceed an average of 60 Mcf per production day, so as to meet the definition of stripper well natural gas under NGPA section 108(b). *See* Interstate Oil Compact Commission, The Oil and Gas Compact Bulletin, Vol. XLIV, No. 1 (June, 1985) at 51.

[95] $4.018 per MMBtu in August 1984.

[96] The stripper well ceiling price as of July, 1986 was $4.615 per MMBtu. Under current conditions it is unlikely a producer will receive anywhere near that price, however.

In this diagram, the section 108 price provides an adequate incentive for Well 1, may provide less than adequate incentive for Well 2 (the production costs exceed the NGPA section 104 price for an extended period before the section 108 price is obtained, and the producer may rightfully question whether the stripper price will clear the market), and provides a definitely inadequate incentive for Well 3.



(Diagram represents locus of supply costs for three old gas wells over time and several price/output relations; these are but three of the multitude of possible cost/output relationships. As pressure drops and production decreases over time, a higher price is needed to prevent abandonment. The NGPA section 108 price may not be the best economic incentive, since to qualify for this stripper well price, output must be no more than 60 Mcf/day (unless special ruling is obtained).)

"x" indicates production greater than 60 Mcf per day, declining, as time passes, until it reaches 60. The curved lines indicate the increase in per unit costs.

old gas can be acquired at a price below that of new gas. This is what the final rule will accomplish, which the mere availability of the section 108 price does not.

AGA also claims that DOE overestimated total national responsive reserves when it scaled down the predicted increase in nationwide recoverable reserves by the ratio of its estimate of responsive reserves to Shell's. Allegedly, this meant DOE failed to account sufficiently for Shell's overestimate of responsive reserves. As explained in Order No. 451, DOE calculated its 66 Tcf estimate of responsive reserves by (1) determining the percentage of each category of gas likely to respond to higher prices allowed by eliminating vintaging, (2) multiplying the amounts of gas in each category on December 31, 1980, by those percentages, and (3) totalling the results. In doing this, DOE relied on data in a study prepared for AGA.[97] AGA alleges DOE made two errors in performing this calculation.

First, AGA contends that DOE erred in including 10 percent of section 105 intrastate gas, or 3.9 Tcf, in responsive reserves. AGA argues that intrastate gas will generally be unaffected by Order No. 451 because most is deregulated and the remainder is either section 105 gas (intrastate gas sold under contracts existing on the date of enactment of the NGPA) not subject to Order No. 451 or is eligible for the higher NGPA section 102 price.[98] The Commission believes that some intrastate gas is properly included in the estimate of gas affected by Order No. 451, and that DOE's estimate of that amount is reasonable for the following reasons. Although Order No. 451 does not permit higher prices for section 105 gas, Order No. 451 does permit section 106(b) gas (intrastate gas sold under rollover contracts) to qualify for higher prices. All section 105 and 106(b) gas sold under contracts

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[97] *See* DOE reply comments at 14.

[98] AGA at 16.

which provided for prices of $1.00 or less on December 31, 1984, remains subject to ceiling prices well below the alternative ceiling price provided by Order No. 451.[99] Thus, all gas presently subject to section 106(b) which was sold under such low-priced contracts is properly included in responsive reserves. So also is section 105 gas sold under such contracts if those contracts will expire in time to permit the gas to qualify for the alternative ceiling price before abandonment.

DOE's estimate of responsive intrastate gas does not include any present section 106(b) gas and to that extent may actually underestimate responsive intrastate gas. DOE does include section 105 gas sold under low-priced contracts which will expire by 1995 permitting the gas to qualify for the section 106(b) ceiling price. DOE appears to have reasonably estimated the amount of that gas. Based on EIA data, which AGA does not contest, DOE states that about 35 percent of intrastate old gas is sold under contracts which provided for prices of $1.00 or less on December 31, 1984. About 28 percent of these contracts will expire by 1995. Since 28 percent of 35 percent is about 10 percent, DOE concluded that 10 percent of intrastate gas (or 3.9 Tcf) may reasonably be considered responsive to the higher prices provided by Order No. 451.[100] The Commission finds the DOE calculation reasonable and rejects AGA's contention that intrastate gas should be excluded altogether from the responsive reserve base. In any event, the Commission observes that intrastate gas accounts for only 5.9 percent of the total 66 Tcf responsive reserve base found by DOE. Thus, even if DOE has overestimated the intrastate gas responsive to elimination of vintaging, the resulting error in the overall 11 Tcf estimate of increased production under Order No. 451 would be minimal.

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[99] *See* NGPA section 121(a)(3), 15 U.S.C. § 3331(a)(3) (1982).

[100] *See* DOE reply comments at 15.

AGA's second criticism of DOE's calculation of responsive reserves is that DOE failed to exclude all gas produced through 1985. Instead, DOE's calculation was based on December 31, 1980 reserves. AGA contends that gas produced or abandoned since 1980 should have been excluded since such gas is no longer available to be produced as a result of the elimination of vintaging. The Commission finds this criticism of DOE's calculation of responsive reserves without merit. In the first place, the increased production as a result of eliminating vintaging is, by definition, production which, because uneconomic, cannot occur under present ceiling prices. Thus, production of gas which is economic under present ceiling prices should not affect the increased production to be obtained through eliminating vintaging unless as a result the gas field is entirely abandoned. It follows that AGA is incorrect in suggesting that production since 1981 under existing ceiling prices reduced the increase in production from eliminating vintaging. Secondly, as explained in more detail in Order No. 451,[101] DOE properly used December 31, 1980 reserves in order to use consistent data in adjusting for the Shell study's overestimate of responsive reserves. The original Shell study had extrapolated the fourteen field results to a national level by multiplying those results by the ratio of January 1981 national reserves responsive to decontrol to January 1981 reserves in the fourteen fields. Shell had estimated January 1981 responsive reserves to be 115 Tcf. Since DOE scaled down its prediction of increased production by the ratio of its estimate of responsive reserves to Shell's 115 Tcf estimate and Shell's estimate was for January 1, 1981, consistency required that DOE use an estimate for the same period. If, as AGA suggests, DOE's estimate of responsive reserves should be reduced to account for production since 1980, then the Shell estimate should also be similarly adjusted so that consistent figures may be used in determining the ratio. If this were done, the ad-

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[101] 51 Fed. Reg. at 22,193.

justments to the two figures would probably approximately cancel one another out, leaving the ratio used to account for Shell's overestimate of responsive reserve approximately the same.

The Commission has now considered all contentions raised on rehearing alleging specific errors in the DOE study. While the Commission has rejected these contentions and continues to believe that the DOE study is the most reliable of the studies concerning supply response in the present record, the Commission wishes to emphasize that no estimate of the increase in recoverable reserves from this rule can be exact. As the Commission stated in Order No. 451, "Overall the only certainty about future natural gas supplies is their extreme uncertainty." [102] Any estimate of increased production under this rule must be based on predictions concerning future market prices and future behavior of producers and purchasers over the next twenty and more years which cannot be made with any certainty. For example, the DOE study is based on a prediction that market prices will rise to the new ceiling price. If they do not, the supply response will not be as great as predicted. In addition, the DOE study assumes that purchasers will not agree in the future to pay a higher percentage of compression costs than they now do. If, however, purchasers did agree to pay a higher percentage of compression costs, some of the supply response predicted by DOE from this rule would occur even if this rule were not adopted. On the other hand, DOE's 11 Tcf estimate of increased reserves does not include any increase in production from water-drive reservoirs as a result of this rule. However, some increased production from partial water drive reservoirs may occur. Some of those reservoirs may be susceptible to permanent loss of recoverable reserves when subjected to sharply curtailed takes of gas. It may well be that more favorable take provisions will be negotiated as a

[102] 51 Fed. Reg. at 22,194.

result of this rule that will permit an increase in the amount of in-place gas resources that will ultimately be recovered. Such higher rates of take and greater recovery of in-place reserves could moderate producer demands for a higher contract price because of the enhanced cash flow resulting from such increased takes.

Nevertheless, regardless of the uncertainties of predicting the precise amount by which recoverable resources will be increased by this rule, the Commission believes it clear that there will be a significant increase. There is a direct relationship between price levels and the length of time operation of a well remains economic. Since pre-1975 gas will receive a substantial price increase as a result of this rule, recoverable resources must also increase. This finding is supported by the fact that all the studies, including AGA's, agree that there will be a significant increase in recoverable resources.

Some rehearing applicants question the general conclusion that eliminating vintaging will substantially increase recoverable reserves. First, several petitioners [103] observe that there is curently a surplus of deliverable gas estimated as high as 2.49 Tcf for 1986. The petitioners claim that it makes little sense to expect additional production to occur during a time of surplus. The Commission disagrees with this contention. The increased production of old gas expected to occur as a result of this rule is from wells which are currently subject to ceiling prices ranging from 52¢ to $1.66 for large producers and 62¢ to $2.18 for small producers. Thus, Order No. 451 will permit much of this gas to receive substantial price increases, thereby making its production economic, and yet still permit it to undersell much gas that is already in the market. There is no reason not to expect such gas to find a market, even during a time of surplus. In any event, as discussed above, the surplus will not last in-

[103] Ohio Consumers Counsel at 7; Florida Cities at 20; Northwest Central at 41.

definitely, particularly in light of the current collapse in drilling activity and the Commission's action to create more competition.[104] DOE, for example, predicts that the surplus will be dissipated by 1988 under current regulation and 1987 if vintaging is eliminated.[105] Most of the increased production from eliminating vintaging will thus occur after dissipation of the surplus.

Some petitioners for rehearing contend that, even if the increased production of old gas occurs and causes overall prices to decline, this will discourage new drilling and result in the abandonment of many existing stripper wells.[106] They argue that over the longer term, the loan of stripper and some new gas production will offset, and thereby cancel out the benefits of, the increased old gas production. The Commission understands that under Order No. 451 some high-cost gas may not be produced immediately in the same time frame as under current regulations because of lower prices in the near term for such gas although the Commission would expect that renegotiation to lower prices will cause some portion of higher priced gas to be produced and sold at lower prices as has occurred in the current market. Exploration for and development of other higher-cost new gas will be delayed. However, these are precisely the intended ef-

[104] The Commission notes that after the Commission issued Order No. 451, the Energy Information Administration (EIA) released the advance summary of its year-end report on the U.S. natural gas reserves. EIA's data indicates overall, natural gas reserve additions in the lower-48 states declined to 77.9% of production in 1985, and U.S. proved gas reserves declined for the fourth year in a row. *See* U.S. Department of Energy, Energy Information Administration, Advance Summary of U.S. Crude Oil, Natural Gas, and Natural Gas Liquids Reserves, 1985 Annual Report (Washington D.C., September 1985).

[105] The overall lower prices brought about by the rule will cause the surplus to dissipate faster than it otherwise would.

[106] Elizabethtown Gas Company (Elizabethtown) at 5; KP&L *et al.* at 25; Florida Cities at 31; AGA at 13; and APGA at 44.

fects of Order No. 451 which will cause overall prices to be less than they otherwise would be. The increased supply of lower-cost old gas will replace some higher cost gas immediately and delays the need to engage in expensive exploration and development of high-cost new gas.

Finally, some rehearing requests reiterate the contention that, even assuming increased production of old gas occurs, it will not be beneficial since its incremental cost will be exorbitant.[107] In response, the Commission reiterates its rationale for rejecting this contention in Order No. 451. The high incremental cost estimates are obtained by determining the purchasers' increased cost of purchasing all old gas as a result of Order No. 451 and dividing the result by DOE's estimate of increases in recoverable reserves. This calculation fails to take into account the reduction in price of high-cost gas which will occur as a result of this rule. The petitioners' contentions that higher cost gas will not come down in price as predicted by the Commission are considered in the next section.[108]

[107] Peoples Gas *et al.* at 13; Cal. PUC at 6; NI-Gas at 13; Florida Cities at 25; AGD at 4; UDC at 42; and Northwest Central at 25, 40.

[108] The Citizen/Labor Energy Coalition (C/LEC) at 4-6 contends that Order No. 451 improperly relied on the May 1986 EIA Study in its findings concerning the supply response. This applicant states that the EIA Study's supply response estimate relied heavily on full implementation of Order No. 436. Without the transportation rights provided by full implementation, the supply response allegedly would decline significantly. It is, of course, true that producers must be able to obtain transportation of their gas in order to obtain the full benefit of the market-responsive pricing permitted by this rule. However, even if Order No. 436 is not adopted by every pipeline, the transportation provisions of Order No. 451 should enable producers to obtain the necessary transportation. Second, the applicant states that the Commission's failure to adopt DOE's proposal for incentive prices would reduce the supply response projected by EIA. However, that failure can have no effect

E. *Price Response*

In Order No. 451, the Commission considered the comments and data in the record regarding the likely impact of the DOE proposal on consumer gas prices and pipelines' weighed average costs of gas (WACOGs). The Commission concluded that the most likely impact would be further downward pressure on consumer prices and WACOGS. It found that the higher ceiling price for old gas would eliminate the price distortions of the old gas cushion. It also found that the higher ceiling price would lead to a reduction in wellhead prices for high-cost gas to market-clearing levels responsive to competition mandated by the NGPA.[109]

The Commission also concluded that, over the long-run, pricing old gas at its replacement cost would call forth additional supplies of gas not likely to be available under vintage pricing, and that these additional supplies would put downward pressure on future wellhead prices.[110] In analyzing the numerous studies and statistics in the record and in the public domain [111] concerning the likely price impact of the DOE proposal, the Commission stated that the real issue was not *whether* over-

on the EIA Study's prediction of an 11.7 Tcf supply response through delayed abandonment. Finally, the Commission notes that in any event it does not rely on the EIA Study in its holdings concerning the supply response except to the extent applicants themselves have relied on the EIA Study to challenge the Commission's holdings.

[109] *See, generally,* Order No. 451, 51 Fed. Reg. 22,195-204 (June 18, 1986).

[110] *Id.* at 22,197-98.

[111] *See* Foster and Reddick, "Analysis of High Cost Gas Purchases by Contract Termination Date," *Gas Energy Review* (Vol. 13, No. 12, American Gas Association, December 1985); AGA Initial Comments, "1986 Base Case, U.S. Energy Information Administration, Analysis of Natural Gas Contracts, Volume I: Old Interstate Gas," *Service Report,* Table 3 (February 1986) (RNGD-86-01).

all gas prices would come down in response to higher old gas prices, it was *how fast* such prices would come down. Based on the record as well as on the behavior of pipeline purchased gas costs (PGAs) before and after the partial deregulation of wellhead prices on January 1, 1985, the Commission concluded that any renegotiation of old gas prices to replacement cost levels under the DOE proposal would be more than offset by reductions in high-cost gas prices.[112]

However, the Commission also found that, despite the likely reduction in overall gas prices, it was impossible to predict with certainty whether some consumers or some pipeline systems would face short term transitional increases in their gas costs before the lower overall prices and enhanced supplies are made available to all pipelines under the rule. For this reason, the Commission modified the good faith negotiation procedure in the final rule in order to give the purchaser the right to renegotiate the prices of all gas, including new gas, in contracts which contain some old gas where the producer requests any old gas price renegotiation. Under this modification, the American Gas Association (AGA) estimated that at least one-third of all new gas potentially would be subject to price renegotiation by purchasers, because it is contained in "multi-vintage" contracts which cover some old gas eligible for renegotiation to the new ceiling price established by the final rule.[113] To the extent large quanities of this new gas, as well as high-cost categories of old gas, are already priced above spot market prices or individual pipeline WACOGs, Order No. 451 concluded that the modifications to the good faith negotiation procedure would give pipeline purchasers substantial added leverage to bargain both old and new gas prices to market-responsive levels.

[112] Order No. 451, 51 Fed. Reg. 22,198-203 (June 18, 1986).

[113] AGA at 4.

Finally, the Commission included two additional protections in Order No. 451.

First, the Commission provided to firm sales customers of a pipeline a right of first refusal to any old gas released by the pipeline to the open market as a result of unsuccessful price renegotiation. This right of first refusal would assure that those customers with least access to alternative gas supplies—especially sole-supplied, full-requirements customers of pipelines that have not chosen to provide open access transportation under Order No. 436—would have the ability to keep inexpensive old gas supplies on-system by matching any bids for the gas released to the open market.[114] In addition, the final rule provides such customers (and others) with transportation authority in order to receive the gas.

Second, the Commission stated its intention to assure that the PGAs reflect prudent renegotiating practices by pipelines under the rule, instead of projecting purchased gas costs based on the worst possible outcome of such renegotiaton.[115] This scrutiny would assure that pipelines cannot choose to pass through to their customers any higher old gas prices requested by producers without exercising their bargaining rights under the good faith negotiation procedure.[116]

For these reasons, the Commission concluded that Order No. 451 would not unreasonably increase consumer gas

[114] Order No. 451, 51 Fed. Reg. 22,207 (June 18, 1986).

[115] In a recent PGA filing by Colorado Interstate Gas Company, for example, the Commission rejected CIG's estimate of the net effect of impending negotiations under Order No. 451 and disallowed recovery of projected gas cost increases for lack of adequate supporting data. 36 FERC ¶ 61,406 (1986). The Commission took similar action with respect to a PGA filing by KN Energy, Inc. which also included an estimate of the net effect of Order No. 451. 37 FERC ¶ 61,198 (1986).

[116] *Id.* at 22,203.

prices over the short-term, and over the long-term reduce city-gate gas prices in response to more competitive wellhead markets and enhanced supplies.[117]

Requests for Rehearing. On rehearing, a number of pipelines, distribution companies, and their trade associations argue that the Commission lacked substantial evidence in the record to determine the impact of the final rule on pipeline WACOGs and consumer prices.[118] These applicants state that the final rule is based on economic theory, not credible evidence, and that there will be substantial pressure on pipelines to bid the highest price for old gas under the rule, because wellhead markets are not workably competitive.[119]

INGAA, AGA, and most pipelines acknowledge that, by including multi-vintage contracts in the renegotiation process, Order No. 451 gives partial recognition to the problem of high-cost new gas contracts. However, they criticize the final rule as being inadequate to remedy the whole problem, because it does not give purchasers the right to bring all gas contracts to the bargaining table.[120] Texas Eastern, Transco, and others argue the final rule will increase old gas prices without forcing high-cost gas

[117] *Id.* at 22,204.

[118] *See, e.g.*, INGAA at 9-11; UDC at 37; Panhandle Eastern Pipe Line Company, Trunkline Gas Company, and Trunkline LNG Company (Panhandle and Trunkline) at 4-5; Florida Cities at 23-24; Northern Natural at 26-32; Southern Natural at 5.

[119] *See, e.g.*, Northwest Central at 2-4; AGD at 10; APGA at 35-45; Northern Natural at 32.

[120] *See, e.g.*, INGAA at 10-11; AGA at 28-29; Northwest Pipeline Corporation at 4; ANR Pipeline Company and Colorado Interstate Gas Company (ANR and CIG) at 9; Natural and United at 2, 7; Transwestern Pipeline Company (Transwestern) at 4; Arkla Inc. (Arkla) at 10-11; Northern Natural at 37; Transcontinental Gas Pipe Line Corporation (Transco) at 4-6; Florida Gas Transmission Company (Florida Gas) at 4, 18-19; Texas Gas Transmission Corporation (Texas Gas) at 5; Texas Eastern at 4-5.

prices down, unless purchasers are given the right to initiate renegotiation of high-cost gas contracts which do not cover some old gas.[121]

Several applicants argue that the final rule will only force pipelines to reduce takes of high-cost gas, thus increasing the take-or-pay costs associated with such contracts. The problem, these applicants say, is not low old gas prices, it is take-or-pay costs.[122] Other applicants allege that the recent decreases in pipeline WACOGs cited in the final rule are largely due to pipelines exercising market-outs and maximixing old gas takes, and that the only high-cost gas contracts remaining are those with rigid, non-market-responsive terms not susceptible to market pressures if old gas prices increase.[123]

A number of applicants argue that the inclusion of multi-vintage contracts in the good faith negotiation procedure will not help "deep cushion" pipelines—those pipelines with large quantities of cheap old gas and very little high-cost gas under the same or other contracts. Notwithstanding any overall reduction in gas prices nationwide, applicants say, these pipelines face inevitable price increases under Order No. 451, because they lack enough high-cost gas to offset against old gas price increases sought by their suppliers.[124]

Some applicants argue that producers will never initiate price renegotiation of their old gas unless they believe that higher prices are available in the marketplace

[121] *See, e.g.*, Transco at 6-7; Texas Eastern at 17-19.

[122] *See, e.g.*, AGD at 8-9; Peoples Gas *et al.* at 8-9; UDC at 52; INGAA at 12-15; APGA at 37-40.

[123] *See, e.g.*, INGAA at 11, AGD at 8-9; MPC NASUCA at 28-30; NI-Gas at 8-12; N.Y. PSC at 15-16; Tennessee Gas Pipeline Company (Tennessee) at 10-13.

[124] *See, e.g.*, Northern Natural at 34-36; Interstate Power Company at 4; Midwest at 1-3; Northwest Central at 45; KP&L *et al.* at 20; Kentucky Public Service Commission (Kentucky PSC) at 2.

for all their gas subject to renegotiation, regardless of whether or not their pipeline purchaser exercises its renegotiation rights. Thus, these applicants say, the final rule guarantees higher prices unless purchasers are permitted to initiate price renegotiation on their own.[125] Similarly, some applicants argue the Commission cannot have it both ways: increased gas supplies cannot result without higher prices to consumers, and lower consumer prices cannot occur without reducing supplies.[126]

On the other hand, some pipelines, distribution companies, trade associations, and state commissions agree with the Commission's conclusion that wellhead markets are workably competitive, or otherwise laud the Commission's goal of raising the ceiling price for old gas to market-clearing levels.[127]

Producer applicants generally agree that under current competitive conditions in wellhead markets, the higher old gas ceiling price will bring prices down to market-clearing levels.[128] But producers argue that the inclusion of multi-vintage contracts is unnecessary to achieve this goal. In support of these conclusions, these applicants cite the experience of wellhead markets under partial deregulation and argue that market forces are forcing renegotiation of high-cost, take-or-pay contracts through the good faith negotiation procedure. Producers also point out that including new gas in the good faith negotiation procedure is unwarranted because issues re-

[125] *See, e.g.*, INGAA at 11; Transco at 4; Pacific Gas and Electric Company (PG&E) at 2, 4; Arkla at 5, 8-10.

[126] *See, e.g.*, Florida Cities at 23-24; Ohio Consumers Counsel at 6-8.

[127] *See, e.g.*, Transco at 4; Cal. PUC at 23-27; El Paso Natural Gas Company (El Paso) at 1-2; Baltimore Gas and Electric Company (BG&E) at 1; Process Gas Consumers Group, American Iron and Steel Institute, and Georgia Industrial Group (PGC) at 2.

[128] *See, e.g.*, Indicated Producers at 2.

lating to take-or-pay and new gas prices would be brought to the bargaining table voluntarily anyway.[129] Finally, producers generally agree that Order No. 451 will go far in removing a primary source of current price disorders in natural gas markets—the "price cushion" created by existing old gas vintage price ceilings.[130]

Maryland People's Counsel and the National Association of State Utility Consumer Advocates (MPC/NASUCA) allege that Order No. 451 will not reduce gas prices because the natural gas industry—including the pipeline segment—is not workably competitive in the absence of meaningful access to transportation. The fact that the wellhead market may be competitive does not mean that the entire industry is competitive, MPC/NASUCA say. Therefore, without transportation access, local distribution companies and consumers will have no alternative to increased old gas costs passed along by pipelines under Order No. 451. MPC/NASUCA also allege, as discussed *supra* in IV. B., that the previous price distortions of the old gas "cushion" have been largely eliminated, and that the current WACOGs of pipelines that enjoyed a cushion are no longer below market-clearing levels and that such pipelines no longer retain artificial advantages over other pipelines in bidding for new gas.[131]

A group of industrial end-users commands the Commission for expanding the scope of the rule to cover multi-vintage contracts, but argues that any old gas price increases should be tied to reductions in high-priced new gas over the same period of time, in order to

[129] *See, e.g.*, Indicated Producers at 4-8.

[130] *See, e.g.*, Independent Petroleum Association of America (IPAA) at 1; Indicated Producers at 2-7.

[131] MPC/NASUCA at 17-26.

avoid any short-term increases in the price of gas on certain pipeline systems.[132]

Florida Cities argue that if the Commission is correct in its finding that wellhead gas markets are competitive, then any increase in old gas prices under Order No. 451 will be matched by a decrease in new gas prices, and the consumer will get no price benefits under the rule.[133] In support of this view, Florida Cities cite the Commission staff's findings in the 1982 Notice of Inquiry on wellhead price issues, as well as a study commissioned by the Natural Gas Supply Association (NGSA).[134] Similarly, AGD argues that contract rigidities, not low old-gas prices, are the real source of gas market distortions, citing the Commission's own conclusions in Order No. 436.[135] Finally, INGAA and others allege that Order No. 451 will increase cash flow to producers, and therefore reduce, not increase, their incentive to renegotiate high-cost problem contracts.[136]

Commission Response. Many of the applications for rehearing on the price response issue appear to misunderstand the Commission's fundamental purpose in promulgating the final rule. As the Commission stated:

> It is clear that consumers have suffered shortages and higher prices under the current price system for old gas, and these distortions can only cause more damage to consumers in the future, if existing reserves continue to be sold on a basis less than replacement cost. Keeping old gas rates below replacement cost can only revive shortages and high prices for future generations of consumers.

[132] *See, e.g.*, PGC at 12-14.

[133] Florida Cities at 2-3.

[134] *Id.* at 23-24.

[135] AGD at 8.

[136] INGAA at 10; Kentucky PSC at 2; N.Y. PSC at 16.

> The final rule is not only intended to balance the interests of present consumers and present producers, it is intended to balance the needs of future consumers for long-term reliable gas service, with the protection of present consumers from exploitation by producers.[137]

For this reason, Order No. 451 does not guarantee a particular wellhead price for old gas to either producers or pipelines. Instead, it leaves to both parties the opportunity to renegotiate old gas prices subject both to the full competitive conditions in wellhead markets mandated by the NGPA *and* to the protection of a just and reasonable price ceiling. In this way, in times of surplus, such as now, old gas prices are likely to fluctuate below the price ceiling and possibly below long-term replacement costs. In times of adjustment as supply and demand move into equilibrium, old gas prices may move higher, but never in excess of the new ceiling price. Under the rule's renegotiation requirement, the Commission has assured that short-term price impacts, if any, are subject to the consent of individual pipeline systems, rather than be incurred suddenly by virtue of the automatic operation of indefinite price escalators in existing contracts.

To the extent old gas prices will be gradually renegotiated under Order No. 451 to market-responsive levels, the Commission and most applicants agree the prices will more closely approximate the replacement cost of all gas. However, to the extent the previous old gas vintage pricing system has permitted a small minority of interstate pipeline systems to artificially maintain their overall gas prices below even today's depressed spot market prices, Order No. 451 is in no way intended to exempt such pipelines—or their customers—from the pressures in the marketplace to renegotiate their prices upward to competitive levels.

[137] Order No. 451, 51 Fed. Reg. 22,203 (June 18, 1986).

On the contrary, Order No. 451 is expressly intended to remove the artificial price advantages these pipelines and their producer suppliers have enjoyed in the past and to instead require them to gradually renegotiate their prices under open market conditions, even if those market conditions may place upward pressure on their WACOGs. The Commission recognized in Order No. 451 that a small number of these pipelines could face gas price increases during a transition period, but that these price increases would not be unreasonable in light of the overall benefits of the rule. For this reason, the Commission rejects those applications which request the rule be modified to guarantee somehow that *no* pipeline will face *any* increased wellhead gas prices under Order No. 451. To guarantee no wellhead price increases whatsoever would undermine the fundamental purpose of the rule, which is to assure that old gas prices will more accurately reflect market clearing prices and thus reduce the previously distorting effect of the old gas vintaging system.

The crux of the price response issue on rehearing, then, is not whether any pipelines and their customers will face higher gas costs, but whether or not any such increases will be unreasonable.

Applicants generally concede that the inclusion of multi-vintage contracts in the "good faith negotiation" procedure will limit substantially the number of pipelines who will be exposed to increased old gas prices without any corresponding "right" to reduce other gas prices. However, applicants variously argue that (1) some pipelines do not possess enough high-cost gas under multi-vintage contracts to offset old gas price increases; (2) some "deep cushion" pipelines do not possess enough high-cost gas to offset against old gas price increases, regardless of multi-vintage contracts; or (3) even if pipelines possess enough high-cost gas, their producers will not initiate old-gas price renegotiation unless they are sure they can obtain higher prices for all their gas, in-

cluding take-or-pay payments for high-cost gas which the pipeline can terminate purchasing under the rule. Therefore, applicants conclude, pipelines and customers inevitably will face unreasonable price increases or lost supplies or both.

In response to these alleged problems, the Commission has reviewed the American Gas Association's (AGA) rehearing application, which included as Appendix A a study entitled "Economic Impacts of Order No. 451."[138] Appendix A analyzed data available to the public on gas contracts between major pipelines and major producers compiled by the Energy Information Administration from FERC Purchased Gas Adjustment Filings covering the first half of 1986. The data indicate for each pipeline the total amount and average contract price of old gas from each producer and the total amount and average contract price of any new gas covered by the same old gas contract. EIA also reports the total volumes and average price for both old and new gas covered by these contracts

[138] Rehearing Petition of American Gas Association, Appendix A, attaching "Economic Impacts of Order No. 451" Docket No. RM86-3-000 (July 3, 1986), (Issue Brief 1986-24); also see "AGA Forecasts Lower Gas Prices for this Winter," *Washington Letter* (American Gas Association, October 31, 1986) ("The nationwide average price of natural gas to residential customers this winter is forecast to be 6 percent lower than the price last winter, $5.28 per MMBTu versus $5.60 per MMBtu, according to an AGA analysis . . . The projection is based on an analysis of PGA filings made with FERC by 25 interstate pipeline companies representing about 95 percent of interstate gas purchases. According to AGA, the PGAs show that, on a nationwide average basis, the price pipelines will pay to buy gas this winter will be 32 cents per MBTu lower than last winter. Analysis of pipeline tariff data indicates that this saving will be passed on to the distribution companies. The average field purchase price projected by the pipelines for this winter is $2.14 per MMBtu, compared with $2.46 per MMBtu last winter, according to the analysis. While average costs vary from one pipeline to another, most systems expect price declines this winter, says AGA").

as well as the total volumes and average price for all contracts with each producer.

Appendix A then asumed a market price of $1.80 per MMBtu, which AAG said is in line with a benchmark refiner acquisition cost of crude oil of $17.50 per barrel and with trends in the spot gas market where prices are generally below $1.50/MMBtu—in some cases below $1.25/MMBtu. The assumed price was also in line with recent market-out prices by interstate pipelines, according to AGA.

For Order No. 451 as formulated, Appendix A also assumed that producers would nominate contracts to only those pipelines where the price of gas flowing under *all* old gas and multi-vintage contracts is less than the assumed $1.80/MMBtu market price. Given that the producer can nominate at any time, AGA said, it is unreasonable to assume that a producer would nominate to any pipeline where, in the aggregate, its average price for all contracts with old gas is above current market prices.

Appendix A also apparently assumed that once a producer nominated its contracts to a pipeline, the pipeline would agree to pay a price for the gas equivalent to the assumed market price, regardless of whether the gas is surplus to the pipeline's system supply needs. Another apparent assumption is that the price of new gas not covered by multi-vintage contracts nominated by a producer will not come down in response to the upward pressure on old gas prices. However, AGA does note recent trends in pipeline purchases indicating that anticipated WACOGs have been reduced from a $2.52/MMBtu average in early 1986 to $2.30 MMBtu at mid-year, due to reductions in takes of new, high-cost gas. In addition, AGA notes that if the market price of gas is in fact lower than the assumed $1.80/MMBtu, the impacts of Order No. 451 would be less than those calculated in Appendix A because fewer volumes of gas would be nominated for renegotiation by producers.

Based on all these assumptions, Appendix A concludes that average pipeline gas costs would be at least $0.08/MMBtu (3%) higher in 1986 than they would otherwise be—a WACOG of $2.60/MMBtu compared to $2.52/MMBtu. According to AGA, this increase would vary significantly among pipeline systems, depending primarily on the amount and price of old gas under contract to each system. Some pipelines would be minimally affected, because their contracts with producers have average prices higher than the current market level. Other pipelines with proportionally more low-cost old gas under contract, could expect their WACOGs to rise as much as $0.53/MMBtu (over 30%), according to AGA.

The Commission has also reviewed the PGA data for the first half of 1986 which underlies AGA's Appendix A. These data, excerpts of which are attached as Appendix B to this order, indicate that 16 of 20 major interstate pipelines have weighed average costs of Order No. 451-eligible, unaffiliated old gas and multi-vintage gas above $1.80/MMBtu. Of the remaining 4 pipelines with WACOGs of unaffiliated old and multi-vintage gas below $1.80/MMBtu, two (Northern Natural) at $1.63/MMBtu and Transwestern at $1.72/MMBtu) serve end-use markets which are subject to either intense interfuel competition (Transwestern)[139] or surplus system supplies

[139] The Commission rejects the contention of the California PUC that Order No. 451 will cause substantial increases in the WACOGs of Transwestern and El Paso, the two interstate pipelines serving California. El Paso's WACOG is even less likely to increase significantly than Transwestern's since the average price of its unaffiliated old gas is $2.12, substantially above AGA's assumed market price of $1.80. The seven California PUC estimates of potential increased annual costs to California consumers under Order No. 451, which range from 79 to 501 million dollars based on varying assumptions concerning the prices of old and multi-vintage gas, all underestimate the ability of purchasers to reduce the price of new, multi-vintage gas under Order No. 451. The estimates assume that the price of new gas in multi-vintage contracts will either (1) not be renegotiated at all, (2) be renegotiated only down to $3.00, or (3) be renegotiated down to $2.58, the new ceiling price, while all old gas is renegotiated up to that ceiling price. However, the purchaser has the right, once the producer seeks a higher price for any old gas, to request that the producer nominate a new price for new gas in multi-vintage contracts or above-market old gas. The purchaser may abandon purchases of such gas if dissatisfied with the price nominated. Given these rights, it seems totally unrealistic to assume that pipelines will continue to pay prices substantially above the current market price of approximately $1.80 for new gas in multi-vintage contracts (or old gas) when the producer seeks a higher price for below-market old gas.

(Northern). Both pipelines have settlements pending before the Commission under which their customers and shippers would be provided open access to alternative suppliers consistent with Order No. 436.

One pipeline (KN Energy at a WACOG of $1.11/MMBtu for eligible old and multi-vintage gas) has as its largest old gas supplier a former affiliate which was spun off recently to KN's common shareholders (Plains Petroleum Corporation). On October 1, 1986, KN filed its regularly scheduled annual PGA which proposed an increase of only 11.83¢/MMBtu in its average purchased gas cost over the next twelve months relating to the net effects of Order No. 451, market-outs, and a decrease in purchases associated with Cities Service. Because KN did not provide adequate support for the projection, the Commission accepted and suspended the PGA increase contingent on KN eliminating the Order No. 451 adjustment without prejudice to KN filing an out-of-cycle PGA with detailed support. 37 FERC ¶ 61,198 (1986).

The final pipeline (Northwest Central with an old and multi-vintage gas WACOG of $1.19/MMBtu) could offset over two-thirds of any old gas price increase to $1.80/MMBtu, by reducing its new gas WACOG from a current $3.63/MMBtu to $1.68/MMBtu, its current all-gas WACOG. This is also a large percentage reduction, but the Commission considers it unlikely that Northwest Cen-

tral's old gas suppliers will be able to sustain price increases in excess of their pipeline purchaser's all-gas WACOG of $1.68/MMBtu. In addition, Northwest Central and its customers apparently recognize the substantial bargaining leverage contained in a right of first refusal such as that given a non-Order No. 436 pipeline's customers under Order No. 451.[140]

The Commission considers it reasonable to conclude that a pipeline experiencing a substantial contraction of its sales demand, as most have since 1982, will have additional bargaining leverage with its old gas producers, especially where its firm sales customers rely on the pipeline's system supply, and interconnecting pipelines have experienced a similar reduction in their sales demand.[141]

The Commission therefore rejects the assertion of the rehearing applicants that pipelines and their customers do not possess enough high-cost gas on their system, whether under multi-vintage contracts or not, to offset old gas price increases. The Commission believes that producers will nominate their old gas contracts cautiously and gradually, consistent with the risks they face in exposing their current old and multi-vintage contracts to the uncertainty of spot wellhead markets in the midst

[140] *See* Northwest Central's Order No. 436 settlement proposal, Docket Nos. RP86-32-000, RP86-68-000, where Northwest sought to reserve the right to defer implementation of the settlement if Order No. 451 is not modified to give a right of first refusal to Order No. 436 pipelines.

[141] In order to assist pipelines in renegotiating their contracts in such situations, the Commission has at certain pipelines' request, authorized blanket limited-term abandonment by the pipeline's suppliers. *See* Southern Natural Gas Co., 36 FERC ¶ 61,401 (1986), and Transcontinental Gas Pipe Line Corp., 36 FERC ¶ 61,403 (1986). Such authority provides pipelines additional flexibility to voluntarily renegotiate high-cost as well as low-cost jurisdictional gas as an alternative to renegotiation under the good faith negotiation rule.

of surplus deliverability and post-NGPA gas-on-gas competition in end-use and city-gate markets. Because of these competitive market conditions, the Commission also concludes that it is likely that old gas price renegotiation on individual pipeline systems will follow the pace of changes in the pipeline's overall WACOG, neither faster nor slower.

The Commission also rejects the allegation by applicants that producers will not initiate old gas price renegotiation unless they are sure they can obtain higher prices for all their gas. This is a circular-argument that old gas prices will not be market-responsive because producers will not seek higher prices unless they perceive that the market is willing to pay those prices. In any case, this argument does not alter the requirements of Order No. 451 that old gas prices be the price negotiated in light of market conditions or the ceiling price, *whichever is lower.*

The objection that Order No. 451's price response consideration is based on economic theory, not substantial evidence, must likewise be dismissed. Applicants' own numerous references to PGA data themselves confirm the downward flexibility of WACOGs since January 1, 1985, and belie the assertion that WACOGs will not be similarly flexible under Order No. 451. The Commission also notes that this WACOG flexibility will only increase as most pipelines elect to offer open access transportation under Order No. 436. The transitional transportation provisions in Order No. 451 assure the availability of this increased flexibility to all pipeline customers, regardless of their status under Order No. 436.

However, the Commission reiterates that it intends to strictly scrutinize pipeline PGAs filed to reflect Order No. 451 price negotiations, in order to monitor closely pipelines who bid the highest price for old gas without exercising their renegotiation rights under the rule. The Commission retains the ability, on a case-by-case basis,

to determine the prudence of pipelines' purchasing practices under the rule.

MPC/NASUCA's assertion that Order No. 451 will increase gas prices unless transportation access is available, must be dismissed.[142] Order No. 451 contains a transitional transportation provision and a right of first refusal which together provide access to transportation even where a pipeline is not an Order No. 436 transporter.[143] In addition, Order No. 451 expressly finds that any unduly discriminatory refusal by a pipeline to provide transportation for old gas released under the rule would constitute a violation of section 5(a) of the Natural Gas Act.[144]

In response to Florida Cities' allegation that Order No. 451 will only transfer income from one group of producers to another without increasing supplies, the Commission reiterates its finding that, over the long-term, the higher ceiling price for old gas will call forth additional old gas supplies as supply and demand move into equilibrium in gas markets. But for the new ceiling price, natural gas markets could face more cycles of boom and bust in the drilling industry such as those that have led to low reserve replacement ratios and shortages to consumers in the past.

In respose to INGAA, AGD, and others alleging that by failing to deal with take-or-pay, Order No. 451 addresses the wrong problem, and contradicts the Commission findings in Order No. 436, the Commission refers applicants to numerous notices of inquiry, proposed and final rules and other orders. Substantial evidence has been presented in all these other dockets as well as in this rulemaking regarding the continuing market distortions

[142] MPC/NASUCA at 17-26.

[143] Order No. 451, 51 Fed. Reg. 22,111-13 (June 18, 1986).

[144] *Id.* at 22,112-13.

caused by below-market vintage price ceilings for old gas.[145] The Commission therefore must reject the argument that Order No. 451 does not address a real problem in gas markets. Furthermore, the Commission believes that, as a general matter, purchasers can, and are, successfully renegotiating high-cost gas contracts with inflexible take-or-pay clauses. Adoption of Order No. 451 should accelerate that process. As the Commission observed in Order No. 451, an NGSA survey of producers shows that they have settled over two thirds of their outstanding take-or-pay liabilities and that most of the remaining liability is of recent origin. Also on NGSA survey of interstate pipeline financial statements filed with the Securities and Exchange Commission shows pipelines repeatedly stating that they expect to renegotiate take-or-pay contracts. Furthermore, an AGA study, submitted with its initial comments and later updated, projects that natural gas markets will force high-cost "market unresponsive" gas prices down 11% a year between 1984 and 1988.[146]

The elimination of vintaging can only accelerate this process. Pipelines will be able for the first time to offer higher prices for old gas in return for voluntary renegotiation of take-or-pay contracts. Furthermore, since the old gas cushion currently protecting high-priced contracts through rolled-in pricing will be eliminated, both pipelines and producers will find it mutually advantageous to renegotiate such contracts in order to retain a market for their supplies in the face of competition from cheaper gas

[145] *See, e.g.*, Order No. 451, 51 Fed. Reg. at 22,175 nn. 60, 61, and 63. *See also*, DOE Proposal, 50 Fed. Reg. 48,540 (Nov. 25, 1985), Interstate Transportation of Gas for Others, 50 Fed. Reg. 114 (Jan. 2, 1985) Notice of Inquiry (NOI); Natural Gas Pipeline Ratemaking, Risk, and Financial Implications After Partial Wellhead Decontrol, 50 Fed. Reg. 3801 (Jan. 28, 1985) (NOI, Phase II); Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 24,130 (June 7, 1985).

[146] 51 Fed. Reg. at 22,197 and 22,202.

and alternate fuels. Presumably, a producer would rather sell gas than have its wells shut in, because the pipeline cannot market the gas under the terms of their original contract, or go through the difficulty of a lawsuit to enforce an uneconomic contract.[147] It appears therefore, that purchasers have sufficient bargaining power to bring down the price of high-cost gas sold under take-or-pay contracts. Order No. 451 further reinforces that power with respect to such gas sold under multi-vintage contracts containing old gas by permitting the purchaser to request that the producer nominate a new price for any gas in such contracts and permitting the purchaser to discontinue purchases if dissatisfied with the producer's nominated price. Furthermore, it is conceivable that successful price negotiation pursuant to or as a result of Order No. 451 of the higher price gas will make the prices more competitive for resale, thus increasing the volume sold and reducing the pipeline purchaser's exposure to potential take-or-pay liability under such contracts. At the same time, however, the Commission does recognize that Order No. 451's substantial downward pressure on high-cost gas prices may expose certain pipelines to some additional liability for take-or-pay pre-payments for gas not taken under certain specific contracts. The Commission also expressly reaffirms its policy to expeditiously review take-or-pay "buyouts," including such "buyouts" under contracts subject to Order No. 451, in order that the parties may adjust to these new competitive pressures as smoothly as possible.

[147] There are often considerable pressures on the producer to produce and sell its gas. In addition to the obvious needs to cover costs, debts, and royalty payments, there is often the risk that a failure to produce will cause the producer to lose the ability to recover the gas or make future recovery more expensive. Water can seep into nonproducing wells, and if the well is in a jointly-owned field an individual producer's show can "drain away" toward other producing wells.

In Order No. 436, we reaffirmed our earlier policy statement on "Regulatory Treatment of Payments Made in Lieu of Take-or-Pay Obligations," and indicated that pipelines may seek to recover take-or-pay buyouts in rate filings under section 4 of the NGA on a case-by-case basis.[147a]

For all these reasons, the Commission denies rehearing on the price response issue, and reaffirms its conclusion that Order No. 451 is unlikely to cause any unreasonable increase in gas prices to consumers or pipelines.

F. *Good Faith Negotiation Rule.* In Order No. 451, the Commission adopted a "good faith negotiation rule" primarily in order to assure that old gas is priced at the lower of the new ceiling price or the market price. While producers must have contractual authority to collect the ceiling price, existing contracts may provide that authority, for example by an indefinite price escalation clause. In order to prevent indefinite price escalation clause from automatically raising prices to the new ceiling price regardless of the market price, the Commission required that parties to existing contracts, who do not voluntarily negotiate a new or amended contract price, comply with the good faith negotiation rule before collecting higher prices. That rule gives both parties an opportunity to assess the value of the gas in light of competition and other market forces. A second purpose of the good faith negotiation rule is to assure fairness in the renegotiation of multi-vintage contracts and give purchasers an op-

[147a] FERC Stats. & Regs. ¶ 30,665 at 31,564. *See also,* FERC Stats. & Regs. ¶ 30,637 (1985). *See also,* orders setting Tennessee Gas Pipeline Co. (RP86-119-003) 36 FERC ¶ 61,032 (1986), Transwestern Pipeline Co. (RP86-126-000) 36 FERC ¶ 61,048 (1986), Mountain Fuel Resources, Inc. (RP86-87-000) 36 FERC ¶ 61,150 (1986), and ANR Pipeline Co. (RP86-169-000) 37 FERC ¶ 61,080 (1986), for rehearing, where the Commission has set for hearing rate proposals addressing costs related to payments for past and future take-or-pay buyouts.

portunity to reduce substantially their cost of new gas contained in multi-vintage contracts. The rule does this by providing for the renegotiation of new gas in multi-vintage contracts containing some old gas. Finally, the Commission sought to encourage voluntary renegotiation of an alternative to the formal procedures of the good faith negotiation rule.

The good faith negotiation rule operates generally as follows. The rule establishes a three step procedure by which contracts are placed on the bargaining table. In step 1, the producer may request the purchaser to nominate a new price for any old gas sold under contracts or service obligations in effect on July 18, 1986, and which authorize a higher price. In step 2, the purchaser may, within 30 days of the producer's request in step 1, request that the producer nominate a new price for any old gas sold under contracts or service obligations in effect on July 18, 1986, and which authorize a higher price. In step 2, the purchaser may, within 30 days of the producer's request in step 1, request that the producer nominate a new price for any old or other gas sold under the contracts covered by the producer's request. In addition, the purchaser may request the producer to nominate a new price for any gas sold under any other contract between the parties which contains some old gas. In step 3, the producer may, within 30 days of the purchaser's request in step 2, request the purchaser to nominate a new price for any old gas in the contracts brought to the negotiating table by the purchaser in step 2.

Once a nomination request is made by either party, the other party has sixty days in which to nominate a price. The party requesting the nomination then has 30 days in which to decide whether to accept the nominated price. However, if the purchaser nominates the highest price permitted by the contract, the producer must accept the nomination. If a nominated price is accepted, sales continue under the existing contract at the nominated price.

If a party rejects a nominated price, it may, upon 30-days notice, cease sales or purchases from the wells subject to the nomination request, and abandonment is deemed granted. However, a producer may not give the 30-day notice until it has entered into a contract to sell the gas to a new purchaser. In the interim between rejection of a nominated price and abandonment, sales continue at the existing price. Whenever any gas previously sold to a non-Order No. 436 pipeline is eligible for release under the good faith negotiation rule, the producer must give the pipeline's firm sales customers a right of first refusal before selling released jurisdictional gas to a third party.[148]

No contract may be renegotiated more than once under the good faith negotiation rule. Parties may renegotiate a contract at any time without using the good faith negotiation rule. However, voluntary renegotiation after July 18, 1986, prevents any subsequent renegotiation of the contract under the good faith negotiation rule, unless the parties mutually agree in writing to retain their rights under the rule.[149] In order to give the parties time to familiarize themselves with the operation of the rule and to voluntarily renegotiate their contracts, the Commission provided that producers may not proceed under the good faith negotiation rule before November 1, 1986.[150] The Commission has since postponed the start of good faith negotiation to December 18, 1986.

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[148] Issues raised on rehearing concerning the right of first refusal shall be considered in the succeeding section of this order.

[149] The parties' right to mutually agree to retain their rights under the good faith negotiation rule was not in the rule as originally adopted by Order No. 451 but was added by the Interim Order on Rehearing issued July 18, 1986.

[150] A chart illustrating the operation of the good faith negotiation rule, as modified on rehearing, is attached to this order as Appendix C.

Rehearing Requests. Pipelines, distributors, and state utility commissions contends that the good faith negotiation rule is illegal and unfairly weighted in favor of producers. They contend that the provision of the rule permitting producers who have rejected the purchaser's price nomination to abandon sales upon thirty-days notice grants blanket abandonment in violation of section 7(b) of the NGA.[151] That section provides that producers may not terminate sales until the Commission has found, after a hearing, that the present or future public convenience or necessity warrants the abandonment. These parties contend that the Commission improperly held that it could provide the required hearing and make the necessary findings on a generic basis in the present rulemaking proceeding. The applicants contend that, in deciding whether abandonment is in the public interest, the Commission must consider a number of factors which require analysis of facts concerning specific persons and transactions such as the relative needs for the gas of the existing and prospective purchasers and the markets they serve. Allegedly, the Commission can consider such factors only on a case-by-case basis. The applicants also observe that the Supreme Court has held that putting the abandonment decision solely in the hands of the producer would violate section 7(b).[152] The applicants contend the good faith negotiaiton rule does exactly that.

Pipelines, distributors, and consumer representatives also contend that the Commission erroneously held that the good faith negotiation rule does not violate the

[151] Pacific Gas & Electric Co. (PG&E) at 17; Cal PUC at 31; Elizabethtown at 7; Missouri PSC at 5; Northern Natural 13; KN at 26; KP&L *et al.* at 16; ANR and CIG at 4; Southern Natural at 16; Union Gas System, Inc. (Union) at 6; AGD at 9, 11; UDC at 12, 45, 48; Northwest Central at 9, 10, 14; APGA at 46-51; Peoples Gas *et al.* at 10.

[152] United Gas Pipe Line Co. v. McCombs, 442 U.S. 529, 539 (1979).

Mobile-Sierra doctrine.[153] In *United Gas Pipe Line Co. v. Mobile Gas Corp.* 350 U.S. 332 (1956), the Supreme Court held that a natural gas company may not unilaterally change its contract, but that the Commission may modify contracts when necessary in the public interest. These petitioners contend that, since the producer initiates renegotiation and decides whether to accept the nominated price or reject it and abandon sales, the rule allows the producer to abrogate the contract unilaterally. The petitioners also contend that the Commission neither made, nor could make, a finding that permitting contract abrogation is in the public interest. They assert that permitting such abrogation under the good faith negotiation rule undermines the stable supply arrangements which the Supreme Court found in *Mobile* were essential to the health of the natural gas industry.

Pipelines, distributors, and consumer representatives also contend that the good faith negotiation rule is unfairly weighed in favor of producers, thereby preventing the achievement of the Commission's goal of creating more market-responsive pricing and the benefits that flow therefrom. The primary objections are (1) that only producers can initiate the process,[154] and (2) that purchasers cannot obtain the renegotiation of contracts containing only new gas.[155] These features allegedly permit

[153] Missouri PSC at 3; Northern Natural at 22; ANR and CIG at 5; UDC at 50; Northwest Central at 31; APGA at 52.

[154] PG&E at 4; NI-Gas at 17; Panhandle and Trunkline at 16; Transwestern at 9; INGAA at 14; Texas Gas at 7; Natural and United at 9; Texas Eastern at 17; Transco at 7; ANR and CIG at 11; Arkla at 8; Florida Gas at 15; Tennessee at 16; AGD at 15; and AGA at 19.

[155] AGA at 28; AGD at 9; Tennessee at 16; MPC/NASUCA at 33; PG&E at 6; Peoples Gas *et al.* at 25; Cal. PUC at 27; Kentucky PSC at 3; NI-Gas at 15; SoCal at 5; Williston Basin Interstate Pipeline Company (Williston) at 12; El Paso at 4; Northwest Pipeline Corporation at 9; Transwestern at 13; INGAA at 14; Texas

a producer to limit renegotiation to situations where its increased revenues from old gas are likely to outweigh its decreased revenues from new gas, and give the purchaser no recourse. In addition, new gas sold separately from old gas is not subject to the good faith negotiation procedures. As a result, petitioners claim, a large proportion of new gas subject to non-market-responsive contracts will never come down in price. In addition, some old gas sold under multi-vintage contracts will not rise in price and therefore will be prematurely abandoned, contrary to the Commission's goal of maximizing production of old gas.

Beyond the alleged discrimination against pipelines generally, petitioners claim that the good faith negotiation rule also discriminates among pipelines in that pipelines purchasing both old and new gas under separate contracts will experience greater increases in their gas purchase costs than those who generally purchase gas under multi-vintage contracts. These petitioners seek modification of the rule to eliminate the alleged discriminatory features; they also seek numerous other changes, including, for example, clarification of the effect of abandonment on a purchaser's take-or-pay obligations.

Most producers do not question the legality of the good faith negotiation rule. However, some contend that permitting purchasers to seek renegotiation of non-jurisdictional gas in multi-vintage contracts containing some old gas is beyond the Commission's authority.[156] These petitioners contend that section 601 of the NGPA expressly prohibits the Commission from regulating the sale of gas removed from its NGA jurisdiction. Therefore, the Commission allegedly erred in holding that it

Gas at 7; Missouri PSC at 7; BG&E at 1; Texas Eastern at 8; Transco at 6; ANR and CIG at 8; Florida Gas at 18; Arkla at 10; D.C. PSC at 4; Northwest Central at 51.

[156] Atlantic Richfield *et al.* at 3, 7.

could subject non-jurisdictional gas to renegotiation as a condition of a producer's eligibility for a higher ceiling price for jurisdictional old gas. Other producers, while not contesting the Commission's authority to include non-jurisdictional gas in the good faith negotiation rule, contend that such inclusion is unwise as a matter of policy.[157] They argue that Order No. 451 amply demonstrates that competition will bring down the price of new gas in any event, and that the inclusion of new gas serves only to render the good faith negotiation rule overly complex and thus discourages negotiations under the rule.

Producers contend that the good faith negotiation rule is unfairly weighed against them in a number of other respects which will be addressed in the succeeding discussion. Producers, like pipelines, distributors, and consumer representatives, request numerous clarifications and minor alterations in the rule.

Commission Response. The Commission will first consider the rehearing applicants' major challenges to the legality of the good faith negotiation rule. It will then address the applicants' various other requests for clarification or modification of the rule.

1. *Legality of the Good Faith Negotiation Rule.*

a. *Abandonment under the Good Faith Negotiation Rule Does Not Violate NGA Section 7(b).*

The Commission firmly believes that Order No. 451's grant of abandonment if the purchaser fails to nominate an acceptable price comports with the requirements of NGA section 7(b). The Commission properly found in Order No. 451, after due hearing, that the present and future public convenience or necessity permit abandonment when the conditions set forth in the good faith ne-

[157] Indicated Producers at 4.

gotiation rule are met. The ultimate criterion in determining whether abandonment should be granted under section 7(b) is the public interest.[158] As the Commission stated in Order No. 451, abandonment under the good faith negotiation rule is in the public interest, since it is necessary to ensure that the goals of Order No. 451 of increased production of old gas and overall lower prices described in sections IV. D. and E. *supra* are achieved. Those goals cannot be achieved unless producers can obtain the market-responsive prices permitted by the rule. Without the possibility of abandonment, purchasers under existing contracts could prevent producers from obtaining those prices by insisting on continuation of the present price. In addition, requiring individual producers to file abandonment applications and considering those applications on a case-by-case basis is an inadequate solution. That would cause lengthy delays before abandonments could be granted, given the vast number of producers in the nation and the Commission's limited resources. Achievement of the goals of increased production and lower overall prices would thereby be substantially delayed. Thus, granting abandonment in the present proceeding, if the conditions set forth in the good faith negotiation rule are met, is in the interest of the natural gas market as a whole and is necessary to bring about market-responsive prices for old gas and overall lower prices.

It is true, as a number of petitioners note, that before granting abandonment the Commission must consider all factors relevant to the public interest and that historically, under standards developed in cases such as *Michigan Consolidated Gas Co. v. FPC*[159] and *Transco, supra*, these factors have included (1) a comparison of the needs

[158] Transcontinental Gas Pipe Line Corp. v. FPC (*Transco*), 488 F.2d 1325, 1328 (D.C. Cir. 1973), *cert. denied*, 417 U.S. 921 (1974).

[159] 283 F.2d 204 (1960), *cert. denied*, 364 U.S. 913 (1960).

of the existing purchaser and the prospective purchaser of the gas and of the markets which each serve, (2) a presumption in favor of continued service and the relative diligence of the respective pipelines in providing for adequate supplies, (3) the contractual arrangements between the parties, and (4) the environmental impact of the abandonment decision. However, in the recent case of *Felmont Oil Corporation and Essex Offshore, Inc.*,[160] the Commission rejected the notion that the public interest cannot evolve as conditions change or that the Commission cannot revisit and revise the abandonment policy of the *Transco* and *Michigan Consolidated* cases in light of changed industry conditions, regulatory context and valid policy objectives. The Commission stated that enactment of the NGPA has virtually eliminated the concerns which formed the basis of the Commission's traditional abandonment policy. Instead, experience under the NGPA demonstrates that reliance on market forces to allocate supplies of gas works to the benefit of the public by preventing shortages. Thus, in *Felmont*, the Commission held that these facts permit the Commission, when considering abandonment applications, to shift its focus, from the interests of specific customers and their access to particular sources of supply, to the interests of the market as a whole. Pursuant to this shift in the identification of the public interest, the Commission in *Felmont* permitted abandonment of certain low-cost old gas supplies which the pipeline had shut in in order to take higher-cost new gas subject to take-or-pay obligations. The Commission stated that such abandonment served the interest of the market as a whole since it would permit the low-cost gas to enter the market place, displace higher-cost gas, and help to reduce the overall cost of gas. So also, by the abandonment granted here through the good faith negotiation rule, the Commission seeks to

[160] Opinion No. 245, Docket No. CI84-10-000, 33 FERC ¶ 61,333 (1985); appeal docketed *sub nom.* Consolidated Edison of N.Y. v. FERC (D.C. No. 86-1168).

permit old gas to enter the marketplace, placing downward pressure on overall prices.

Of course, as petitioners for rehearing point out, the Commission in *Felmont* stated that it would continue to weigh the factors which it previously considered, including the parties' comparative needs, their contract arrangements, and the environmental and economic consequences of the abandonment. And the petitioners observe that the Commission did carefully consider those factors in *Felmont*, considering evidence concerning the specific parties there involved. The petitioners contend that the Commission has not, and cannot, consider those factors in the present rulemaking proceeding, since such consideration requires case-by-case analysis.

In this proceeding, the Commission could and did consider all relevant factors involved in determining the overall public interest. The Commission believes that generally a purchaser's loss of gas under abandonment provisions of the good faith negotiation rule should not cause it, or the market it serves, to experience a shortage of supply. The move to market-responsive prices for new gas over the last eight years under the NGPA has already eliminated shortages of gas. Allowing old gas prices also to rise to market-responsive levels up to replacement cost will ensure that present adequate supplies of gas continue into the foreseeable future.[161] Therefore, there is no reason to believe that purchasers losing supplies under this rule should have difficulty replacing those supplies. In addition, the lower overall prices brought about by this rule should allow the purchaser to replace lost supplies at reasonable prices.[162] Furthermore, this

[161] *See* the discussion in Part IV. D. above.

[162] In short, the Commission relies on market forces to assure that purchasers have adequate supplies at reasonable cost. Such reliance on market forces in the context of NGA section 7(b) is supported by the Supreme Court's decision in *FCC v. WNCN Listeners Guild*, 450 U.S. 582 (1981). That case involved a similar

rule protects the interests of the firm sales customers of non-Order No. 436 pipelines by granting them a right of first refusal. Of course, initially at least, some persons, particularly those who benefited from the distortions inherent in the old vintage-based calling price structure, may experience price increases. However, such isolated instances are outweighed by the benefits to the market as a whole described above. Since abandonment occurs under the good faith negotiation rule only if the purchaser has chosen not to pay the price provided for under the contract, in effect terminating the contract, there is nothing in the parties' contractual arrangements militating against abandonment. The presumption in favor of continued service under these circumstances is outweighed by the need to obtain the overall benefits for the public described above.[163] As the Commission discusses in sec-

requirement that the FCC determine whether the "public interest, convenience, and necessity" permit radio station license renewals or transfers. Among the factors to be considered in making the necessary determination is whether granting the renewal or transfer will promote diversity in entertainment programming. The FCC issued a policy statement that it would not consider this factor in individual cases since it could rely on market forces to promnte diversity. The Supreme Court upheld the policy statement, holding that the FCC had provided a rational explanation of its reliance on the market. In the present order and in Order No. 451, the Commission has provided a detailed explanation why under this rule market forces should assure adequate supplies at reasonable costs. *See* Order No. 451, 51 Fed. Reg. at 22,194-22,204. *See* sections IV. E. and G. of this order.

[163] The relative diligence of purchasers in providing for adequate natural gas supplies has less relevance in determining the public interest in a time of surplus rather than shortage. That factor is primarily of use in determining relative equities when allocating shortages among two pipelines that both lack adequate supplies. When all purchasers have adequate supplies, it is difficult to find that any have lacked diligence in obtaining such supplies. The effect of this rule is to provide an adequate economic incentive to ensure production of available lower-cost reserves that otherwise probably would not be available to those purchasers.

tion V. C. of this order, the Commission does not believe that this rule will have any significant adverse environmental consequences. The Commission concludes that it properly found in Order No. 451 that granting abandonments under the good faith negotiation rule is required by the public interest. Since the public interest is "the ultimate criterion under section 7(b)," [164] the standards for granting abandonment under section 7(b) have been met.[165]

The Commission also rejects rehearing applicants' contention that granting abandonment under the good faith negotiation rule is contrary to *United Gas Pipe Line Co. v. McCombs*, 442 U.S. 529 (1979). In that case, the Supreme Court reversed a lower court holding that, upon depletion of reserves, a producer may abandon sales without obtaining any prior Commission approval. The Court reasoned that permitting abandonment without prior Commission approval would leave the abandonment de-

[164] *Transco*, 488 F.2d at 1328.

[165] Some applicants also rely on various statements in Order No. 436-A (50 Fed. Reg. at 52,259) concerning the expedited abandonment policy established in Order No. 436 (*see* 18 C.F.R. § 2.77) to contend that the Commission must consider abandonments on a case-by-case basis. It is true that in Order No. 436-A the Commission emphasized that abandonment applications based on the Commission's policy statement at § 2.77 would be granted only on a case-by-case basis. However, nothing in that order was intended as a statement that the Commission could not in appropriate circumstances grant abandonment in a rulemaking proceeding such as the present. For the reasons stated above, the Commission believes that it is appropriate to grant abandonment in the final rule when the conditions set forth in the good faith negotiation rule are met. Furthermore, the Commission observes that, at the request of certain pipelines, it has granted limited-term abandonment authority to numerous suppliers of the pipeline rather than as in *Felmont*, considering only the abandonment of a specific contract between one producer and the pipeline. *See, e.g.*, Southern Natural Gas Co., 36 FERC ¶ 61,401 (1986) and Transcontinental Gas Pipe Line Corp., 36 FERC ¶ 61,403 (1986).

termination "as a practical matter, in the producer's control, a result clearly at odds with Congress' purpose to regulate the supply and price of natural gas." [166] The present case is distinguishable from *McCombs* since no abandonment without prior Commission approval is here involved. The Commission has in Order No. 451 granted prior approval of abandonments under the good faith negotiation rule as being in the public interest.

One applicant [167] asserts that section 1(a) of the Interstate Commerce Act (ICA) has been interpreted as requiring the Interstate Commerce Commission (ICC) to consider requests for abandonment of service by railroads on a case-by-case basis. The applicant notes that section 1(a) of the ICA is virtually identical to section 7(b) of the NGA, requiring a finding that the "present or future public convenience and necessity" permits abandonment of service. Accordingly, the applicant argues that section 7(b) should also be interpreted as requiring case-by-case consideration of abandonment requests.

The Commission's review of precedent concerning the ICC's authority under section 1(a) and other relevant provisions of the ICA indicates that, far from supporting the proposition that section 7(b) of the NGA requires case-by-case determinations, that precedent supports the Commission's grant of abandonment in Order No. 451. Both sections 14 and 210 [168] of the ICA, requiring that the ICC find that grants of a license to engage in particular activities are in the "public interest," have been interpreted as permitting the ICC to make generic findings applicable to all license applications that the public

[166] 442 U.S. at 539.

[167] Northwest Central at 13-14.

[168] 49 U.S.C. §§ 10924 and 10930. (Former sections 14 and 210 have recently been revised and recodified as §§ 10924 and 10930).

interest standard is met.[169] This is so even though the ICC previously granted such licenses on a case-by-case basis. Since the ultimate criterion under section 7(b) of the NGA is also the public interest, these cases support the Commission's action here. Of the two cases cited by the applicant, one [170] merely states generally that the ICC must balance the interests of presently served customers with those of the carrier and the transportation system. It does not state that the balancing must be done on a case-by-case basis. The other [171] does contain dicta that certain legislative history relied on by the appellant for one point does not address that point, but indicates "that 'public convenience and necessity' must be determined in each case on the basis of the factors that are presented in that instance. *See* H.R. Rep. No. 456, 66th Cong. 1st Sess. 146-52 (1919)." The Commission's review of the document cited reveals no indication that findings of public convenience and necessity must be made on a case-by-case basis. Rather, the essential issue raised in the course of legislative consideration of the section appears to have been whether the states or the Federal government should have jurisdiction to make the determinations.

Finally, the Commission has provided the hearing required by section 7(b) in the present proceeding. The Commission has provided all segments of the natural gas industry an opportunity to file initial and reply comments. Two days of public hearings were held. All interested persons have had the opportunity to present further arguments on rehearing. The only argument as to why this opportunity for hearing is inadequate is that

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[169] American Trucking Associations, Inc. v. United States, 602 F.2d 444 (D.C. Cir. 1979). National Tour Brokers Ass'n v. ICC, 671 F.2d 528 (D.C. Cir. 1982).

[170] Chicago and North Western Transportation Co. v. Kalo Brick & Tile Co., 450 U.S. 311, 321 (1981).

[171] Farmland Industries Inc. v. U.S., 642 F.2d 208, 211 n.5 (7th Cir. 1981).

the Commission allegedly cannot consider all relevant factors, including the effects of individual abandonments on affected parties, other than on a case-by-case basis. That argument has been answered above.[172]

b. *The Good Faith Negotiation Rule Does Not Violate the Mobile-Sierra Doctrine.*

The Commission also rejects contentions by various rehearing petitioners from all segments of the natural gas industry that the good faith negotiation rule violates the *Mobile-Sierra* doctrine. Pennzoil Company and Pennzoil Producing Company contend that the good faith negotiation rule unlawfully abrogates indefinite price escalation clauses in existing contracts. Those clauses allegedly authorize collection of the just and reasonable rate established by this rule. Yet the good faith negotiation rule does not permit a producer to collect that price until it has given the purchaser an opportunity to renegotiate the contract in question and certain other contracts. Pennzoil argues that, since the Commission has found the new ceiling price to be just and reasonable, the Com-

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[172] Some applicants claim that in Order No. 451 the Commission improperly relied on Phillips Petroleum Co. v. FPC, 475 F.2d 842, 848-52 (10th Cir. 1973) and American Public Gas Ass'n v. FPC, 567 F.2d 1016, 1064-67 (D.C. Cir. 1977), in holding that the hearing provided in the present proceeding satisfies the section 7(b) hearing requirement. The Commission disagrees. While those cases involved the issue whether the Commission may entablish area and national rates in rulemaking proceedings without violating the hearing requirements of NGA sections 4 and 5, those sections require similar findings concerning the public interest as does section 7(b). Applicants also attack the Commission's reliance on Texaco v. FPC, 377 U.S. 33, 44 (1964), and FPC v. Moss, 424 U.S. 494, 500-01 (1976). The Commission recognizes that those cases are not precisely on point. Nevertheless, *Texaco* supports the proposition that the Commission has discretion to establish expeditious administrative methods in order to achieve its regulatory purposes and *Moss* supports the proposition that the Commission may pregrant abandonment even though years may elapse before the abandonment actually occurs.

mission cannot make the requisite finding that abrogation of the indefinite price escalation clause is in the public interest.

The Commission first observes that it has not found that automatic collection of the new ceiling price is necessarily appropriate, even though the new ceiling price is within the zone of reasonableness for replacement costs, and therefore just and reasonable. The Commission recognizes that the new ceiling price may be above prevailing market prices. Accordingly, the Commission adopted the good faith negotiation rule, as an integral part of obtaining the new ceiling price, in order to assure that producers do not collect above-market prices for gas under existing contracts with indefinite price escalation clauses. Without that rule the price of the 90 percent of old gas sold under such contracts would automatically escalate to the ceiling price regardless of the market price. This would not be a just and reasonable result in the sense of providing for the lowest reasonable rate under MGA section 5(a). Thus, the requirement that producers comply with the good faith negotiation rule clearly is in the public interest, and provides for a transitional gradation toward the ultimate just and reasonable ceiling available under the rule.

Furthermore, the Commission believes that that rule does not abrogate indefinite price escalation clauses for the same reasons the court in *Pennzoil Co. v. FERC* (*Pennzoil II*)[173] held that the Commission's requirement of specific contractual authority for collection of the section 107(c)(5) ceiling price also does not abrogate indefinite price escalation clauses in violation of the *Mobile-Sierra* doctrine. As the Commission made clear in Order No. 451, indefinite price escalation clauses may provide the necessary *contractual* authority to collect the alternative ceiling price; however, in order to assure that the

[173] 671 F.2d 119, 124-25 and nn.13 and 14 (5th Cir. 1982).

rate actually *collected* is just and reasonable, the Commission requires compliance with the good faith negotiation rule unless the parties voluntarily renegotiate. In other words, while the indefinite price escalation clause continues to provide contractual authority to collect the highest just and reasonable price allowed by law, the alternative ceiling price is allowed by law only if parties specifically agree to it under the good faith negotiation rule or otherwise. Since the ceiling price adopted under sections 104 and 106 is just and reasonable and since the purpose of the good faith negotiation rule is to assure that the price collected thereunder is the lowest just and reasonable price within that ceiling, the rule clearly furthers the Commission's legitimate regulatory policies.[174]

Pipelines, distributors, and consumer representatives also claim that the good faith negotiation rule violates the *Mobile-Sierra* doctrine, although for different reasons. They claim the rule permits producers to terminate contracts unilaterally and that the Commission cannot make the necessary finding that such termination is in the public interest since it adversely affects pre-existing supply arrangements. The Commission fully discussed this issue in Order No. 451. While permitting producers

[174] This discussion should alleviate the concern of one applicant (El Paso at 16-18) that, because the Commission allegedly has found the new ceiling price to be just and reasonable, an indefinite price escalation clause might be interpreted as agreement to pay the new ceiling price. Under this interpretation, a purchaser's failure to nominate the new ceiling price would constitute a breach of the indefinite price escalation clause. As stated above, the Commission has not found automatic collection of the new ceiling price necessarily just and reasonable. It is only just and reasonable to the extent agreed to under the good faith negotiation rule or as a result of voluntary renegotiation. Thus, no purchaser is in any way obligated to pay the new just and reasonable ceiling price. Rather, the producer, as a condition of eligibility for making a transition toward the higher rate, is required to give the purchaser an opportunity to negotiate for a lower price.

and purchasers to terminate their contracts, the good faith negotiation rule requires that as a condition for seeking the alternative ceiling price otherwise provided for by the contract's indefinite price escalation clause, producers must give the purchaser an opportunity to seek a lower price under that contract and certain other contracts. Any termination of the contract results from the purchaser's decision to offer a price lower than that provided by the contract. Since any contract termination occurs only through the parties' mutual exercise of their rights under the good faith negotiation rule, there is no unilateral contract termination in violation of the *Mobile-Sierra* doctrine. Nor is there any need for the Commission to make a finding that permitting unilateral abrogation of the contracts is in the public interest, since none is permitted. In any event, in the discussion above finding that abandonment under the good faith negotiation rule is permitted by the public convenience or necessity, the Commission has shown that any mutual contract termination and abandonment which occurs under the good faith negotiation rule is in the public interest in spite of its effect on the parties' past supply arrangements.

c. *The Commission Has Authority to Permit Purchasers to Seek Lower Prices for Non-Jurisdictional Gas under the Good Faith Negotiation Rule.*

Several producers [175] contend that the Commission exceeded its authority by permitting purchasers, in step 2, to seek a lower price for any new gas, including non-jurisdictional gas, in any contract between the parties which includes old gas. These applicants point out that NGPA section 601 removes certain new gas from the Commission's NGA jurisdiction. They assert that conditioning a producer's right to obtain the new just and reasonable rate for old gas on renegotiating non-

[175] Atlantic Richfield *et al.*

jurisdictional gas amounts to backdoor regulation of that gas in violation of NGPA section 601. They find support for this view in *Pennzoil Co. v. FERC* (*Pennzoil I*) 645 F.2d 360 (5th Cir. 1981), holding that the Commission lacks authority to regulate non-jurisdictional gas sales in the guise of contract interpretation.

The Commission has not exceeded its authority. It does not seek to reregulate sales of non-jurisdictional gas through the good faith negotiation rule. Rather, as described above, it seeks to establish a condition of eligibility to ensure that the price collected for old jurisdictional gas is just and reasonable. As described in Order No. 4517, purchasers may have agreed to a higher price for new gas, including non-jurisdictional gas, in a multi-vintage contract in reliance on the fact that the lower cost of the old gas reduced the average price under the contract. The Commission believes that in such circumstances it would be unjust and unreasonable for the producer to collect, pursuant to the new price ceiling, a higher price for the old gas, whether from the existing purchaser or from a new purchaser after abandonment, without giving the existing purchaser under the contract an opportunity to renegotiate the price of the new gas. The Commission also believes it would be unjust and unreasonable to permit a producer to renegotiate only those multi-vintage contracts where it will gain a net increase in price because the contracts contain primarily old gas. The provision of the good faith negotiation rule permitting purchasers to seek a lower price in step 2 for any gas in contracts containing some old gas follows from this reasoning. Accordingly, the Commission believes that, pursuant to its authority recognized in *Pennzoil II* to define criteria for eligibility for a ceiling price in order to further its legitimate regulatory policies, it may include this provision in the good faith negotiation rule.[176]

[176] *See also* Texas Eastern Transmission Corp. v. FERC, 769 F.2d 1053 (5th Cir. 1985).

The producers seek to distinguish *Pennzoil II* primarily on two grounds. First, they contend that the rationale of that case applies only to "special rates," such as the NGPA section 107(c)(5) ceiling price, which Congress authorized the Commission to establish "to the extent necessary" to achieve a stated goal. Eligibility criteria allegedly are permissible as a means of limiting the special rate to that gas which requires the special rate to achieve the stated goal. Producers claim that rates established under sections 104 and 106 are not such special rates. However, the Commission sees no significant distinction between the rate involved in *Pennzoil II* and that involved here. The Commission may establish higher ceiling prices under section 104 and 106 only to the extent such prices are just and reasonable under the NGA. As described above, that is the purpose of this condition in the good faith negotiation rule.

Second, producers contend that the Commission cannot find, as required by *Pennzoil II*, that the condition here involved is reasonably calculated to further its legitimate regulatory policies. The producers claim that the regulatory policy here involved is the prevention of premature abandonment of low-cost old gas, that requiring producers to submit non-jurisdictional gas to renegotiation does not serve this purpose, and that to do so is contrary to the stated goal, since some producers may thereby be discouraged from seeking the price increases for old gas necessary to keep that gas in production. Producers also state that, since the Commission expects new gas prices to be renegotiated downward in any event, there is no need to require producers to submit new gas sold under multi-vintage contracts to renegotiation in step 2.

The Commission believes that the condition here involved is reasonably calculated to further its regulatory policies. When the Commission establishes a just and reasonable rate, it must balance a number of factors, some of which conflict with one another. In the present

case, the Commission must balance the need for higher prices for old gas to avoid premature abandonment with fairness to purchasers. The Commission recognizes that conditioning higher prices for old gas on renegotiation of the price of any other gas may discourage some producers from seeking higher prices and thus reduce to some extent the increased production sought in this rule. On the other hand, purchasers may have relied on low prices for old gas in agreeing to pay higher prices for new gas, whether that new gas is in multi-vintage contracts or not. Thus, failure to condition higher prices for old gas on renegotiation of other gas prices may involve unfairness to purchasers. The Commission has balanced these two concerns by conditioning higher prices for old gas on renegotiation only of the price of new gas sold under multi-vintage contracts between the producer and purchaser including some old gas. Requiring the renegotiation of all new gas prices, including that sold under separate contracts, could make the rule so costly to producers that few would seek higher old gas prices, thereby preventing achievement of the rule's goal of increased old gas production. Also, the relationship between old and new gas prices is less clear when the two are sold under separate contracts. However, as discussed above, where the two are sold under the same contract, the contractual relationship is so intertwined that it would be unfair to allow renegotiation of one of the strands of consideration to permit higher old gas prices with no provision for renegotiation of other threads of the contractual balance related to new gas prices.

It is true that the Commission expects new gas prices to be renegotiated downward as a result of the market forces released under this rule. However, there could, over the short term, be a lag between a producer obtaining a higher price for old gas under the good faith negotiation rule and market forces having their full effect on the new gas price. The purchaser's rights in step 2 assure that lag does not occur with respect to new gas sold

in multi-vintage contracts. The fact that market forces will bring down new gas prices does, however, reduce the Commission's concern about the fairness of excluding from step 2 of the good faith negotiation rule new gas sold separately. Finally, since about two thirds of new gas is sold under separate contracts,[177] limiting the new gas the producers must submit to renegotiation to new gas sold with old gas means that the costs of seeking higher prices for old gas should not be so high as to discourage producers from seeking higher prices for a sufficient amount of old gas to permit significant increased production. The Commission concludes that permitting purchasers to seek renegotiation of the price of all new gas, including non-jurisdictional gas sold in contracts with old gas, furthers the Commission's legitimate regulatory policies and is permitted by the authority to establish eligibility requirements for NGPA prices confirmed in Pennzoil II. The Commission has not reregulated new gas. Rather, it has simply sought to assure that the price obtained for jurisdictional sections 104 and 106 gas is just and reasonable.

d. *The Good Faith Negotiation Rule Is Not Unfairly Weighted in Favor of Producers.*

The Commission now turns to contentions of many pipelines, distributors, and consumer representatives that the good faith negotiation rule is unfairly weighted in favor of producers, since only producers can initiate the process and purchasers cannot obtain renegotiation of new gas not sold in multi-vintage contracts with old gas. These provisions of the rule allegedly have three major discriminatory effects preventing achievement of the Commission's goal of market-responsive pricing for all gas. First, they allow most high-cost, non-market-responsive new gas to escape downward renegotiation under the good faith negotiation rule. As previously

[177] AGA at 4.

noted, approximately two thirds of new gas is sold in separate contracts containing no old gas which cannot be renegotiated under the good faith negotiation rule.[178] Also, not all of the remaining high-cost gas will be renegotiated under the good faith negotiation rule. The fact that only producers can initiate good faith negotiation allows producers to limit renegotiation under the rule to situations where the potential for increased revenues from higher old-gas prices outweighs the risk of decreased revenues from lower prices for new gas sold with old gas. The failure of the good faith negotiation rule to reach non-market-responsive, new-gas contracts allegedly means that overall gas prices will increase as a result of higher old-gas prices, since applicants believe that the Commission's contention that competition will lower the price of high-cost gas apart from the good faith negotiation rule is unsupported by substantial evidence.

The second discriminatory effect alleged by applicants is that some purchasers will be more adversely affected than others. Some purchasers buy a higher percentage of their new gas under multi-vintage contracts than do others. Those purchasing more of their new gas under separate contracts will have less ability to renegotiate downward the price of that gas than those purchasing

[178] A number of applicants claim that the exclusion of new gas sold under separate contracts from the good faith negotiation process is particularly arbitrary in light of two additional factors. First, the rationale for inclusion of new gas in multi-vintage contracts allegedly applies equally when old and new gas is sold to a purchaser under separate contracts. In both cases, the purchaser relied on its ability to roll in the low-cost old gas with high-cost new gas in agreeing to pay higher prices for the old gas. Second, the decision whether to include old and new gas in on contract or separate contracts was largely an arbitrary drafting decision. Indeed, the Commission allegedly encouraged separate contracts under § 272.102(c) of its regulations as in effect before 1980 (AGA at 30-31).

more of their new gas under contracts containing old gas. Similarly, producers selling most of their new and old gas under separate contracts will obtain a higher net price increase than those selling more gas in multi-vintage contracts.

Finally, applicants contend that, to the extent producers refrain from seeking higher prices for their old gas under the good faith negotiation rule in order to avoid renegotiation of the price of new gas sold under multi-vintage contracts, the beneficial effects claimed by the Commission from higher old-gas prices will not occur. The old gas will be prematurely abandoned. This will impede achievement of the Commission's goal of lowering overall prices.

Applicants contend that for these reasons the good faith negotiation rule is arbitrary and capricious, grants undue preference to particular producers and pipelines and provides for unjust and unreasonable rates in violation of NGA section 5. Applicants propose two main changes in the rule to avoid these problems and provide market-responsive pricing for all gas. First, they propose that purchasers be permitted to initiate good faith negotiations, at least with respect to any contract containing any old gas. Applicants contend that, having found the present vintage-based pricing system unjust and unreasonable, the Commission has the legal authority under NGA section 5 to allow purchasers to initiate good faith negotiations as the necessary remedy to eliminate the present unjust and unreasonable rates. Second, they propose that, once the producer seeks a higher price for any old gas, the purchaser should be able to seek lower prices for new gas covered by any contract between the parties, regardless of whether that contract contains old gas. The applicants argue that, if the Commission has legal authority to condition eligibility for higher old gas prices on renegotiating all gas in multi-vintage contracts, that same authority permits it to condition higher old-

gas prices on renegotiation of gas in all contracts with the purchaser. Another proposal is to allow any purchaser from a particular producer to exercise its rights under step 2 of the good faith negotiation rule once that producer has requested one of its purchasers to nominate a price in step 1.[179]

Tennessee[180] proposes a more radical solution of replacing the entire good faith negotiation rule with a requirement that bilateral market-out clauses be included in all contracts. Process Gas Consumers Group (PGC)[181] proposes that the Commission require that a producer be required to file an affidavit agreeing to renegotiate fully all its contracts with any interstate pipeline that accepts Order No. 436 before seeking a higher price under any contract. PGC contends this would give pipelines a greater incentive to accept Order No. 436 and also make a producer more willing to risk potential renegotiation of all its higher priced supplies since the pipeline's acceptance of Order No. 436 would give the producer needed non-discriminatory access to wider markets for all its gas, not just released supplies.

The Commission does not believe that the good faith negotiation rule as adopted is discriminatory or that it must be altered to permit purchasers to initiate the process and to renegotiate all new gas prices. Applicants' contentions proceed from a false predicate; they assume that non-market-responsive, high-cost new gas prices will not come down unless purchasers are given a means to bring them down under the good faith negotiation rule. This is not true. As explained in detail in Section IV. E. of Order No. 451,[182] the Commission believes that competitive

[179] AGA at 27; PG&E at 5; NI-Gas at 17; Williston at 12.

[180] at 4-9.

[181] at 12-14.

[182] 51 Fed. Reg. at 22,194-22,197.

forces in the natural gas market, including competition from alternative fuels, increased production of old gas, and more accurate price signals, will force down the price of non-market-responsive gas, wholly apart from the good faith negotiation rule. Therefore, it is unnecessary to modify the rule in any of the ways suggested in order for the increased production of old gas encouraged by this rule to bring overall prices down. The two-thirds of new gas which cannot be renegotiated under the good faith negotiation rule will nevertheless respond to competitive forces in the natural gas market which will be strengthened by increased production resulting from this rule. The record amply demonstrates that higher gas prices have, in fact, fallen as a result of competitive forces.[183] Also, producers not immediately initiating good faith negotiation, because they believe any increased revenues from old gas will be more than offset by lost revenues from new gas sold with old gas, will find the price of their high-cost gas nevertheless coming under heavy competitive pressure as other producers take advantage of the rule. Purchasers may reduce takes of the high-cost gas. Thus, it may well become worthwhile for them to seek the higher prices permitted by the market for their old gas in order to offset the inevitable decline in the price of their high-price gas.

The fact that high-cost gas will respond to competitive market forces even though not subject to renegotiation under the good faith negotiation rule should also prevent the various other discriminatory effects alleged by applicants. Because prices of all new gas will come down, purchasers buying their new and old gas under separate contracts should not experience higher gas costs over the long term any more than those purchasing such gas under

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[183] See also "First to Pay, Last to Gain," a report by the Citizen/Labor Energy Coalition issued October 1986, showing that from the first half of 1984 to the first half of 1986 the wellhead price of gas dropped 65 cents per Mcf or 24 percent.

multi-vintage contracts. Producers selling most new and old gas under separate contracts should not obtain higher prices than those selling primarily under multi-vintage contracts. Also, since most producers are likely to seek eventually over an extended period of time higher prices for old gas, little old gas will remain at present low regulated prices and thus be prematurely abandoned, contrary to some applicants' contentions.

For these reasons alone there is no need to amend the good faith negotiation rule to avoid discrimination. In addition, there are other grounds for rejecting the proposed amendments to the good faith negotiaion rule. First, the Commission doubts its authority to permit purchasers to initiate the process, since that might result in purchasers' unilaterally terminating high-cost contracts in violation of the *Mobile-Sierra* doctrine as embodied in NGPA section 101(b)(9).[184] Under the good faith negotiation rule as adopted, if the producer does not want to risk the pipeline terminating purchases of high-cost gas, it need not invoke the good faith negotiation procedures. The purchaser too has an opportunity to prevent the contract from terminating, by paying the contract price or voluntarily renegotiating. Thus, termination of purchases results only from mutual decisions by the producer and purchaser. The situation would be very different if the purchaser could invoke the good faith negotiation procedures; then the purchaser's right to terminate would arise not because the producer chose to grant the purchaser such a right as a condition of obtaining the benefit it sought. Rather, the purchaser's right to terminate would arise from its unilateral action in initiating good faith negotiation.

Nor is the Commission convinced by the applicants' contention that it has authority to grant purchasers the right to initiate good faith negotiation under section 5 of the

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[184] *See* Pennzoil Co. v. FERC, 671 F.2d 119, 125 (5th Cir. 1982).

NGA. Applicants contend that that authority arises because the Commission has found in Order No. 451 that the present pricing structure is unjust and unreasonable. However, the Commission only found that the present rigid, vintage-based old gas price structure is unjust and unreasonable. The Commission has not found that gas prices for new gas are unjust and unreasonable. In fact, the current much lower prices for large amounts of new gas renegotiated or subject to market outs could not be found unjust or unreasonable. In any event, the Commission lacks authority to find new gas prices unjust and unreasonable. Some new gas prices are set pursuant to NGPA price ceilings and the remainder are set in the open market pursuant to deregulation. All such rates are deemed to be just and reasonable under section 601(b) of the NGPA. However, based on the Commission's finding that the old gas prices had become unjust and unreasonable, the Commission reformed the old gas pricing structure to set new just and reasonable ceiling prices pursuant to NGPA sections 104 and 106. Accordingly, it provided for renegotiation of new gas prices only where the old and new gas volumes were so inextricably intertwined, because covered by the same contract, that such renegotiation may be conceived of as part of the adjustment of the old gas price under the contract. All terms of such a multi-vintage contract are so-interrelated that it would not be equitable to adjust the old gas prices under the contract without allowing the new gas price aspects of the contract to be open to adjustment in turn.

While rehearing applicants have argued for the Commission's authority to permit purchasers to seek renegotiation of all new gas prices, including that not sold with old gas, after producers have initiated the process, the Commission believes there are strong policy reasons not to do so, apart from the fact competition will force down new-gas prices in any event. If a producer's request for the purchaser to nominate a new price for old gas in step 1 instantly gave the purchaser the right to renegotiate all other contracts with the producer including those not containing old gas, the potential cost to a producer of initiating good faith negotiation would in many instances undoubtedly be greater, perhaps far greater, than under the current procedure so that fewer producers would initiate the process. This would seriously impede achievement of the Commission's goal of market responsive prices for old gas so as to avoid premature abandonment of that gas. Without higher prices for old gas and the resulting increased production of old gas, the competitive pressures forcing down high-cost prices would be lessened.

The Commission rejects the contention that it arbitrarily distinguished new gas sold in multi-vintage contracts containing some old gas from new gas sold separately. It is, of course, true that purchasers may have relied on their ability to roll in high-cost new gas with low-cost old gas in agreeing to pay a higher price for the new gas, regardless of whether the new gas was purchased in a multi-vintage contract with old gas or separately. In striking the balance previously described between the need for higher prices for old gas and fairness to purchasers, the Commission determined that fairness to purchasers required giving them a right to renegotiate under the good faith negotiation rule all new gas sold under the same contract with old gas. This assures that there is no significant lag between the producer's obtaining a higher price for old gas sold under such contracts and the purchaser's obtaining a lower price for the new gas. Again, all terms of multi-vintage contract relations are interrelated and it would not be fair to disrupt the mutuality of consideration between the parties. Accordingly, the rule applies to such contracts. However, in order not to render negotiations under the good faith negotiation rule so costly to producers so that in the short run few would initiate such negotiations, the Commission believes it appropriate to exclude new gas sold under separate contracts from negotiations under the good faith negotiation rule. While this may result in some lag between the producer's obtaining a higher price for the old

gas and the purchaser's obtaining a lower price for the new gas, the market forces released by this rule, including more accurate price signals and increased production of old gas, should bring down the price of the new gas sold under separate contracts. Therefore, the Commission concludes that exclusion of that gas from the good faith negotiation process is not unfair to purchasers.

The Commission also rejects the separate proposals of Tennessee and PGC. The Commission believes these proposals to be unnecessary since, as stated above, new-gas prices are expected to come down in any event. In addition, since as explained above, the Commission has not found new-gas prices to be unjust and unreasonable, the Commission doubts its authority to require market-out clauses to be included in all contracts. In any event, while the Commission recognizes the value of market-out clauses in encouraging market-responsive pricing, such clauses should be adopted through negotiation between the parties, not Commission fiat. The Commission is handicapped in analyzing PGC's proposal by the fact that the details of that proposal are unclear. For example, PGC does not state what rights Order No. 436 pipelines would have if they failed to reach agreement with the producer on a lower price for new gas. If the existing contract price would continue in effect, the proposal appears to grant pipelines no additional rights over what they now have. Presumably, however, PGC intends the pipeline to have rights similar to those granted under the good faith negotiation rule. Granting Order No. 436 pipelines greater bargaining rights than non-Order No. 436 pipelines and other purchasesrs who are not pipelines at all appears unfair and possibly in violation of the prohibition against undue preference. Furthermore, allowing all Order No. 436 pipelines the right to demand lower prices for new gas or terminate purchases if the producer seeks a higher price for any old gas with any purchaser appears to suffer from the infirmity that it would discourage producers from seeking higher prices

for old gas, thus impeding achievement of the goals of this rulemaking.

For all of the above reasons, the Commission rejects the contention that the good faith negotiation rule is unfairly weighed in favor of producers because it does not permit purchasers to initiate the process and does not provide for renegotiation of new gas sold under separate contracts. The Commission accordingly declines to adopt any of the various suggestions to alter these features of the rule.

2. *Response to Other Suggested Clarifications and Modifications of the Good Faith Negotiation Rule.*

The Commission has now considered all of the major challenges to the legality of the good faith negotiation rule made by rehearing applicants. Applicants from all segments of the natural gas industry have, however, also requested numerous clarifications and alterations of specific aspects of the good faith negotiation rule. Most applicants seek to increase the bargaining rights of their segment of the industry. Since the Commission believes that bargaining rights under the rule as adopted are balanced, it generally rejects the suggested modifications. However, the Commission does make several minor changes in the rule.

The Commission will first consider (a) issues involving generally the three-step nomination procedure by which contracts are placed on the bargaining table for negotiation under the good faith negotiation rule. It will then discuss, in order, (b) issues specifically concerning the producer's right in step 1 to request that the purchaser nominate a new price for old gas, (c) issues concerning the purchaser's right in step 2 to request that the producer nominate a new price for any gas in the contract placed on the bargaining table in step 1 or any other contract including old gas, (d) issues concerning the producer's right to request that the purchaser nomi-

nate a new price for old gas in contracts brought to the bargaining table in step 2, (e) issues concerning the rule that no contract may be renegotiated more than once under the good faith negotiation rule, (f) issues concerning the parties' rights to abandon sales or terminate purchases of gas, and (g) issues concerning the operation of the good faith negotiation rule in certain specific situations.

a. *General Issues Concerning the Three-Step Nomination Procedure*

First, several applicants[185] request that the Commission postpone the start of negotiations under the good faith negotiation rule from November 1, 1986 to at least January 1, 1987. These applicants contend that otherwise old gas price increases and abandonment may occur during the winter heating season. Also, one contends that a delay will provide more time for resolution of Order No. 436 settlements, thus enabling both pipelines and their customers to make their pricing decisions based on more accurate knowledge of the market structure under which they will be operating. Finally, they express concern that good faith negotiation might start before the Commission acts on their rehearing requests.

The Commission has previously postponed the date on which a producer is permitted to make a nomination request until December 18, 1986 in order to assure that no party is required to renegotiate a contract under the good faith negotiation rule until the Commission has resolved the issues raised on rehearing.[186] In this order, the Commission further postpones the initiation of good faith negotiation until [insert date 30 days after publication of this order in the *Federal Register*]. The amendments to the good faith negotiation rule adopted in this order do not become effective until that date. This further post-

[185] *See* Minnesota DPS at 8 and NI-Gas at 22-23.

[186] 37 FERC ¶ 61,077 (1986).

ponement of the initiation of good faith negotiation will therefore avoid any confusion which might otherwise arise if the rule were changed after negotiation had already begun under it. The postponement of the initiation of good faith negotiation ensures that no abandonments or price increases not agreed to by the purchaser will occur during the winter heating season. The purchaser may prevent any abandonment from occurring until at least 90 days after the [insert date 30 days after publication of this order in the *Federal Register*] start of good faith negotiation, or [insert date 120 days after publication of this order in the *Federal Register*] and probably longer. A purchaser has up to 60 days to respond to a producer's nomination requests. If the producer rejects the price nomination, it must negotiate a contract with a new purchaser, and then give the purchaser 30-days notice before abandoning the sales to the purchaser. Furthermore, if the pipeline is a non-Order No. 436 pipeline and the new purchaser is not a firm sales customer of that pipeline, the producer must also give the firm sales customers a right of first refusal, a process taking an additional 30 days, before giving the 30-days notice of abandonment. The only price increases occurring under the good faith negotiation procedures significantly before [insert date 120 days after publication of this order in the *Federal Register*] would be those resulting from a producer's acceptance of the purchaser's price nomination.[187] Since such price increases are voluntarily agreed to by the purchaser, the Commission sees no reason to postpone their effect through further delaying initiation of the good faith negotiation rule. The Commission also does not believe that any further delay in the effectiveness of the good faith negotiation rule would significantly affect the number of pipelines whose Order No. 436 status has been clarified.

[187] These could occur by about 60 days after initiation of good faith negotiations, or [insert date 90 days after publication of this order in the *Federal Register*.]

A large number of applicants, primarily pipelines and distributors,[188] request that the Commission require that all producer requests for price nominations under the good faith negotiation rule be made within a specified period after the date when producers may initiate good faith negotiation. Many suggest one year as an appropriate period. The applicants contend that without this requirement producers might postpone exercising their rights under the good faith negotiation rule indefinitely, waiting for market conditions to improve so that they can obtain a greater increase in old gas prices while incurring a smaller decrease in new gas prices. This allegedly would permit the indefinite continuation of the present vintage-based rates found unjust and unreasonable in Order No. 451 in violation of NGA section 5, and postpone achievement of the Commission's goals of increased production of old gas and resulting lower overall prices. Also, purchasers' uncertainty over their supply arrangements allegedly would be indefinitely prolonged. Finally, when price increases did occur, they would be unreasonably large because obtained during a time of shortage.

The Commission has determined not to place a time limit on initiation of good faith negotiation. The purpose of this rulemaking is to create market-responsive pricing for old gas up to replacement costs. A limitation on when the producer can invoke good faith negotiation would be contrary to this goal. It is difficult to see any significant harm to an individual purchaser from a producer's delay is seeking renegotiation, since the purchaser is entitled to continue to buy the gas at the existing low price until renegotiation is sought. If the

[188] Tennessee at 24; PG&E at 5; Peoples Gas *et al.* at 24; Cal PUC at 28; SoCal at 2; Panhandle and Trunkline at 15; El Paso at 15; Northwest Central at 54; Transwestern at 16; AGA at 25; INGAA at 16; Texas Eastern at 19; Transco at 8; ANR and CIG at 23; D.C. PSC at 5; Arkla at 14; Florida Cities at 8; Arkla at 14; and Florida Gas at 22.

purchaser is concerned about security of supply, it can seek to enter long-term contracts with other sellers or offer voluntary renegotiation to the existing seller. Furthermore, the Commission anticipates that the effect of good faith negotiation nationwide will probably be a gradual phase-in of the higher old gas prices in an evolutionary fashion reflecting individual producer decisions on initiation and continued voluntary negotiation. An arbitrary time limit could force either premature initiation with a rush of good faith negotiation nationwide or in the alternative the loss of good faith negotiation rights by many producers unwilling to initiate the process before the deadline. The Commission wants to ensure that it provides fully for the evolutionary phase-in of higher old gas prices over time to maximize the price and supply responses. Finally, the Commission rejects the contention that NGA section 5 requires limiting the time in which the producers can initiate good faith negotiation in order to force elimination of current unreasonable rates. The Commission has found that the existing rigid vintage-based old gas pricing structure is unjust and unreasonable. By establishing the alternative ceiling price and permitting producers to seek higher prices under the good faith negotiation rule, the Commission has eliminated the existing rigid old gas pricing structure by permitting market-responsive pricing up to replacement cost. Having done that, the Commission should now let the market work and not interfere in it by specifying the time in which producers must exercise their rights.

Third, several applicants[189] request that the Commission clarify that a party requested to nominate a new price may also seek changes in the non-price terms of the contract. The Commission agrees that when a party is requested to nominate a new price, it may include in its nomination changes in any term of the contract. It would

[189] AGA at 35 n.44; INGAA at 17; Panhandle and Trunkline at 17; and ANR and CIG at 21.

be inconsistent with the Commission's goal of encouraging market-responsive pricing to limit the contract terms subject to renegotiation. Terms other than price can have a significant effect on the economic value of a bargain to either party.[190] Parties should not be restricted in the types of contract changes they can make in order to reach agreement on a new contractual relationship satisfactory to both. Accordingly, paragraph (a)(7) has been included in § 270.201, as revised.

However, the requirement that the producer accept the purchaser's nomination of the highest price permitted under the contract will not apply if the purchaser nominates the highest price permitted by the contract but includes in its nomination a change in another contract term. The reasons for requiring the producer to accept a nomination of the highest permitted price is that the purchaser has agreed to abide by the existing contract, which provides for payment of that price. If the purchaser seeks to change terms in the contract, then it has not agreed to abide by the existing contract. Furthermore, it would be improper to allow a purchaser to impose on the producer a change in any contract term by the simple expedient of including such change in a nomination of the highest permitted price. No change in the contract should occur other than through the mutual agreement of the parties.[191] Section 270.201(d) and (e) have been amended accordingly.

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[190] This does not, however, make non-price terms part of the price paid under the contract. *See* Declaratory Order, Transportation of Liquid and Liquefiable Hydrocarbons by Natural Gas Pipelines, 22 FERC ¶ 60,013 (1983), *reh'g denied*, 24 FERC ¶ 61,004 (1983); *aff'd*, Texas Eastern Transmission Corporation v. FERC, 769 F.2d 1053 (5th Cir. 1985), *cert. denied*, 106 S. Ct. 1967 (1986).

[191] Tennessee contends (at 20-22) that the producer should at least be required to accept the purchaser's nomination where it nominates the highest permitted price but seeks insertion of a market-out clause. Tennessee argues that this would provide for more market-responsive pricing of gas in the future. For the reasons stated above, the Commission rejects this proposal. While the Commission recognizes the value of market-out clauses in encouraging market-responsive pricing, the Commission believes that insertion of such clauses into contracts should not occur through Commission fiat or the unilateral action of one party, but through mutual agreement of both parties in light of current market conditions. A party desiring a long-term agreement without a market-out clause should have the ability to negotiate for such agreement through offering appropriate inducements to the other party.

One applicant[192] requests that the Commission clarify the mechanics of requesting and making price nominations under the good faith negotiation rule. First, it suggests that both parties be required to send their requests for price nominations by U.S. mail, return receipt requested. Since the 60 days for responding to the nomination request run from the day of receipt, this requirement would enable the person making the request to know when the 60-day period begins to run. The Commission adopts this suggestion. Not only will this provision enable the sender to know the date of receipt, but also it is consistent with the requirements in § 270.201 (g)(2) and (3) that the tender of the right of first refusal and its acceptance be made by U.S. mail, return receipt requested. For the same reasons, the Commission similarly requires that responses to nomination requests and acceptance or rejection thereof, as well as notices of abandonment or termination of purchases, be made by U.S. mail, return receipt requested.[193]

Second, the applicant seeks clarification of when nominations should be considered as having been made. Consistent with the usual rule that service of a document is accomplished on the date it is deposited in the mail,[194] a party's price nomination will be considered made on

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[192] Tennessee at 33-34.

[193] Accordingly, paragraph (a)(5) has been included in § 270.201, as revised.

[194] *See* 18 C.F.R. 385.2010(g)(1) (1986).

that date. Finally, the applicant asks to whom nomination requests and price nominations should be addressed and whether the contract's notice provision governs. The notice provision does govern. In the absence of such a provision, the parties should work out this matter among themselves.[195]

On applicant [196] states that the purchaser's price nomination in response to the producer's step 1 nomination request should be due on the same day as the producer's price nomination in response. to the purchaser's step 2 nomination request. The rule, as adopted, provides for the purchaser's price nomination to be made 30 days before the producer's. The applicant argues that this is unfair since it allows the producer to see the purchaser's nominated price before it nominates a price for the gas covered by purchaser's nomination request. The Commission rejects this proposal. While the producer can see the price nominated by the purchaser before nominating a price in response to the purchaser's step 2 nomination request, the purchaser can see the producer's nominated price before responding to the producer's step 3 nomination request. These sequential price nominations are inherent in the structure of the good faith negotiation rule, and the Commission does not believe that any imbalance in the parties' negotiating rights results.

b. *The Producer's Rights in Step 1*

A producer cannot request the purchaser to nominate a higher price under the good faith negotiation rule unless its contract provides authority for collection of the higher

[195] As the Commission stated in Order No. 451, parties may extend any deadlines for action under the good faith negotiation rule by mutual agreement. In response to an applicant's request (Indicated Producers at 22), the Commission has codified this right in § 270.201(a)(6) of its regulations.

[196] Northwest Central at 57.

price.[197] In Order No. 451 the Commission stated that if a contract contained an indefinite price escalation clause but the parties had executed an amendment providing for a fixed price lower than the applicable maximum lawful price for a set period less than the term of the contract, the producer could make a nomination request at any time but any new price agreed to would not take effect until expiration of the fixed price. An applicant [198] states that such amendments may be for indefinite periods, for example until further notice or until some benchmark price is reached. It requests that the Commission clarify the producer's rights under the good faith negotiation rule in such circumstances. The Commission believes that the same rule should apply regardless of whether the amendment is for a definite or indefinite period, but it has determined to modify the rule stated in Order No. 451 so that the producer may not request that the purchaser nominate a price until the fixed price amendment has expired pursuant to its terms. Thus, in the situation hypothesized by the applicant, no nomination request may be made until the necessary notice is given or the benchmark price is reached.[199] This rule is necessary to prevent the producer from obtaining a right to abandon sales through rejection of the purchaser's nominated price before it has contractual authority to increase prices. It is also consistent with the general principle that pro-

[197] § 270.201(a)(2)(ii)(A).

[198] ANR and CIG at 29.

[199] Of course, if the contract also covered some gas with a price ceiling lower than the price set in the fixed price amendment, the producer could, before the amendment expired, request that the purchaser nominate a higher price for that gas up to the price set by the amendment. However, such request would prevent the producer from making any subsequent nomination request under the good faith negotiation rule after the fixed-price amendment expired. *See* § 270.201(a)(4)(ii).

ducers must have contractual authority for higher prices in order to initiate good faith negotiation.[300]

A contract must have been in effect on July 18, 1986, in order to be renegotiated under the good faith negotiation rule. One producer applicant,[301] however, contends that where a producer signed a rollover contract before issuance of Order No. 451 but the contract had not been signed by the purchaser by July 18, 1986, signature by the purchaser after July 18, 1986, should not preclude the contract from renegotiation under the good faith negotiation procedures even though the contract was not in effect on July 18. Without this change, the applicant claims, the purchaser could deny the producer its right to renegotiation under the good faith negotiation rule by purposefully delaying signing the rollover contract. The Commission sees no reason to change the rule as suggested by this applicant. Once the Commission had issued Order No. 451 on June 6, the producer should have been as aware of its rights under Order No. 451 as the purchaser. If the producer wanted to reconsider its offer to the purchaser in light of Order No. 451 it should have withdrawn that offer. If it failed to do so, the purchaser would be entirely within its rights to sign the contract and a binding agreement would result not subject to renegotiation under the good faith negotiation rule.

One producer applicant[302] requests that the Commission modify the provision that the producer must accept the purchaser's nomination of the highest price

[300] This rule would not apply where the purchaser had imposed a unilateral price increase moratorium. In that case, since the producer had not agreed to the moratorium, the producer would retain contractual authority to collect a higher price and could initiate good faith negotiation any time after [insert date 30 days after publication in the *Federal Register*].

[301] Amoco Production Company (Amoco) at 8.

[302] Plains Petroleum Company (Plains) at 2-4.

permitted by the contract to make that provision inapplicable where that contract contains a market-out clause. The applicant contends that otherwise the provision would permit a purchaser to deprive the producer of its right to abandon sales or obtain transportation to an alternative purchaser by nominating the highest price and then, a month later, exercising the market-out clause to reduce the price of the gas. The Commission will not modify the good faith negotiation rule as suggested. The producer, having originally agreed to the market-out clause, should abide by the consequences of its agreement. Since market-out clauses encourage market-responsive pricing, the Commission sees no reason why it should interfere with their operation in a rulemaking designed to encourage market-responsive pricing. In any event, if the situation postulated by the applicant were to occur, the applicant would not be entirely without remedy. It could apply to the Commission for an individual abandonment pursuant to NGA section 7(b).

Finally, another producer applicant[303] requests that the Commission permit a producer, when it makes a nomination request in step 1, to stipulate that neither it nor the purchaser can make any nomination requests with respect to casinghead gas sold under contracts otherwise subject to the negotiations. Casinghead gas is a byproduct of oil production. The applicant's primary reason for desiring the right to exclude casinghead gas is apparently that a purchaser's termination of purchases of such gas under the good faith negotiation rule might adversely affect the producer's oil production. Conceivably, if the producer could not find an alternative purchaser for the casinghead gas, the producer could be required to shut in the oil production.

The Commission refuses to adopt the applicant's suggested modification of the good faith negotiation rule. It would be contrary to the Commission's goal of market-responsive pricing to allow the producer to insulate cer-

[303] Indicated Producers at 16.

tain gas from renegotiation. The producer should take into account any concern about the effect of abandonment on its oil production in deciding whether to initiate good faith negotiations and whether to accept the purchaser's nominated price. In addition, as will be described later, the Commission is lengthening the notice the purchaser must give the producer before terminating purchases. This should give the producer a greater opportunity to find another purchaser for the casinghead gas and avoid any loss of oil production. The Commission concludes that the suggested modification would add unnecessary complexity to the good faith negotiation rule.

c. *The Purchaser's Rights in Step 2*

A number of applicants request clarifications concerning precisely what contracts containing some old gas the purchaser may bring to the bargaining table in step 2. First, clarification is sought concerning precisely what gas is considered old gas for purposes of permitting the purchaser to put a contract on the bargaining table. For example, if a contract contains gas committed or dedicated to interstate commerce on the date of enactment of the NGPA which now receives the section 108 stripper price, could the purchaser bring that contract to the bargaining table in step 2?[204] The old gas must be actually priced under NGPA sections 104 and 106. Thus, a contract containing all new gas on July 18 except for some old gas priced under section 108 could not be brought to the bargaining table by the purchaser. The Commission's rationale for including contracts containing some old gas in step 2 would not apply in such circumstances since the purchaser could not be relying on low-priced section 104 or 106 gas to bring down the average price paid under the contract to reasonable levels.[205]

[204] *See* ANR and CIG at 26 and IPAA at 3.

[205] Paragraph (a) (2) (i) has been included in § 270.201, as revised, to clarify the definition of "old gas."

Second, one applicant[206] asks *when* the contract must contain old gas. It observes that a contract may have originally covered old gas but later all the old gas wells may either have qualified for NGPA incentive prices or been abandoned. It suggests that the Commission require that the contract cover old gas on the date the first seller makes his nomination request in step 1. The Commission agrees that to avoid ambiguity there must be a reference date for purposes of determining whether a contract covers old gas. However, the Commission believes that that date should be the effective date of this rule, July 18, 1986. This date will enable all parties to determine with certainty what contracts are potentially subject to good faith negotiation. It will also prevent a producer from insulating a contract from renegotiation by delaying initiation of the good faith negotiation procedures until all that contract's old gas wells are abandoned or qualify for NGPA incentive prices. A contract will be considered to cover old gas if on July 18, 1986 it covered any wells subject to the section 104 or 106 price ceilings for which the Commission has not authorized permanent abandonment. Thus, the mere fact no old gas was sold on that date does not necessarily mean that the contract does not cover old gas.[207] The requirement that abandonment have been granted should avoid disputes whether a well was only temporarily shut in or depleted.[208]

[206] IPAA at 2.

[207] Paragraph (a) (2) (ii) (B) is included in § 270.201, as revised, to resolve this ambiguity.

[208] For the same reasons, the expired contracts subject to renegotiation under the good faith negotiation rule will be considered to include all expired contracts as to which the Commission has not authorized abandonment as of July 18, 1986. Gas sold under the expired contract need not have actually been flowing on July 18, 1986. This rule provides certainty as to which expired contracts are subject to the good faith negotiation rule. The Commission recognizes that in some instances abandonment may not have been granted even though all gas well subject to the expired contract are

Third, one applicant [209] requests clarification whether, when a purchaser has contracts naming different divisions of a single corporation as the seller, and the producer makes a nomination request with respect to one division's contract, the purchaser may bring to the bargaining table the other division's contract in step 2. Another applicant [210] requests clarification that, where a producer has contracts with two affiliated corporations and requests one to nominate a price, the other may not seek renegotiation in step 2, of its contracts. The Commission believes that, for purposes of determining whether a "purchaser" has contracts with a "seller" containing some old gas subject to renegotiation in step 2, individual corporations should be considered single, but separate, sellers and purchasers. Thus, two divisions of one corporation are nevertheless the same seller, and the purchaser may bring to the bargaining table all contracts with both divisions. However, affiliated corporations with separate corporate identities are separate purchasers (or sellers), and contracts with one affiliate cannot be brought to the bargaining table in step 2 if only a contract with the other was brought to the bargaining table in step 1.

Fourth, one applicant [211] requests clarification whether an umbrella settlement covering many separate contracts, some containing old gas and some only new gas, is an existing contract subject to renegotiation in step 2. If such an umbrella settlement is an existing contract, the purchaser could seek to renegotiate the new gas contracts solely because the producer previously agreed to provide

depleted. However, in many such circumstances, neither party is likely to have an interest in renegotiating the contract in any event, and the rule should cause no hardship.

[209] El Paso at 20.

[210] Samson Resources Company (Samson) at 3-4.

[211] Indicated Producers at 29.

price or take-or-pay relief in the umbrella settlement. The Commission agrees that a producer should not be penalized for entering into such umbrella settlements. It intends that the phrase "existing contract . . . that includes the sale of any old gas" [212] should refer to base contracts, not umbrella settlements.

Fifth, two applicants request clarification whether a producer's request, after expiration of an existing contract, to collect the new ceiling price under a rollover or replacement contract triggers the purchaser's rights under step 2 of the good faith negotiation rule. Amoco [213] states that a producer's request for a rollover contract at the new ceiling price should not constitute a nomination request under the good faith negotiation procedures permitting the purchaser to obtain renegotiation of other contracts containing old gas in step 2. ANR and CIG,[214] however, take the opposite position, stating that the occurrence of a contractual rollover should constitute a request for a price nomination under the good faith negotiation rule to the extent the underlying contract contains an indefinite price escalation clause.

The Commission generally agrees with Amoco, not ANR and CIG. The good faith negotiation rule applies only to contracts (or the underlying service obligation) in effect on July 18, 1986. When a producer seeks to negotiate a rollover contract after July 18, 1986 to replace an expired contract, it is negotiating a contract not in effect on July 18, and the good faith negotiation rule in inapplicable. Negotiation of the rollover contract is entirely voluntary, and neither party thereafter has any rights under the good faith negotiation rule. If a producer and pipeline voluntarily enter a rollover contract, the execu-

[212] § 270.201 (b) (2).

[213] at 8.

[214] at 28-29.

tion of the rollover terminates any further rights under the good faith negotiation rule.

Of course, old gas sales may be continuing under the expired contract pursuant to the service obligation of a certificate of public convenience or necessity. If the service obligation was in effect on July 18, 1986,[215] the producer may pursuant to the good faith negotiation procedures seek a higher price for old gas sold under an expired contract pursuant to the service obligation. However, if the producer does so, the purchaser may in step 2 seek renegotiation of all other contracts with the producer containing old gas. In the absence of the purchaser's agreement to a higher price either voluntarily or under the good faith negotiation procedures, the producer may not collect from the new ceiling price for gas sold pursuant to a service obligation. If the producer could collect up to the new ceiling price without the purchaser's agreement, there would be no assurance that the producer was obtaining mutually agreeable prices. This would violate the Commission's objective of permitting collection only of mutually agreed-upon prices or the ceiling price, whichever is lower.

Sixth, two applicants [216] express concern that some producers may seek to avoid renegotiation of their new gas in step 2 by transferring or assigning either their old gas or their new gas to an affiliated entity so that all new and old gas is in separate contracts. The Commission does not believe that this is a significant danger under the rule as adopted. More assignment to another corporate entity of old or new gas covered by a multi-vintage contract without amendment of the sales contract itself could not insulate the new gas from renegotiation in step 2. This is because the original owner of the gas would still appear

[215] Even if the contract expired after July 18, 1986, the service obligation is considered to have been in effect on that date so long as the contract was in effect on that date.

[216] ANR and CIG at 22 and Arkla 12.

on the contract with the purchaser as the seller of that gas. The purchaser is entitled to obtain renegotiation in step 2 of all gas sold under the contract as it was on July 18, 1986, by the seller regardless of whether the seller claims someone else owns the gas. Furthermore, if the contract were amended after July 18, 1986, to reflect the assignment, the amendment would deprive the producer of any rights under the good faith negotiation rule in any event, unless both the producer and the purchaser mutually agreed in writing to preserve their rights under the good faith negotiation rule.[217]

Finally, the provision for purchasers to make a nomination request in step 2 with respect to the same gas subject to the seller's step 1 nomination request [218] has caused confusion among some rehearing applicants. Some applicants appear to believe that a purchaser's request that a producer nominate a price for old gas covered by the producer's nomination request relieves that purchaser of its obligation to nominate a price in response to the producer's nomination request, thus depriving the producer of the opportunity to accept or reject a price nomination by the purchaser.[219] One applicant requests that the Commission amend the rule to eliminate any right by the purchaser in step 2 to request the producer to nominate a price for gas covered by the producer's step 1 request.

The Commission permitted purchasers to make nomination requests with respect to gas covered by the pro-

[217] The Commission disagrees with Arkla's concern about possible circumvention between the June 6, 1986 issuance of Order No. 451 and July 18, 1986, since, as noted above, purchasers had the ability to protect themselves during that period by refusing to agree to contract amendments. Purchasers should have been as aware of their step 2 rights during that period as sellers. In addition, there is no evidence that sellers sought to separate a significant amount of new gas from old gas during that period.

[218] 51 Fed. Reg. at 22,208, note 261.

[219] *See* Indicated Producers at 31-32 and Amoco at 8-9.

ducer's request so that purchasers and producers would have identical bargaining rights with respect to old gas. Without this provision, the producer could foreclose the purchaser from obtaining a lower price for, or terminating purchases of, any old gas by including all such gas in its nomination request in step 1. Even if the purchaser nominated a price lower than the existing contract price in response to the producer's nomination request, the producer could simply reject the purchaser's nomination and continue sales at the existing contract price. Accordingly, the Commission believes that this provision should be retained. However, the Commission does not clarify that a purchaser's request in step 2 that the producer nominate a price for old gas covered by the producer's request in step 1 does not relieve the purchaser of its obligation to nominate a price in response to the producer's request. Rather, in such circumstances negotiations must continue under the good faith negotiation rule until either (1) one party has accepted the other's price nomination resulting in a binding contract at the accepted price or (2) both parties have rejected the other's price nomination resulting in each having the right to terminate sales or purchases.

d. *The Producer's Rights in Step 3.*

One applicant [220] requests that the Commission permit a producer in step 3 to request that the purchaser nominate a price for any gas, including new gas, which the purchaser introduced in step 2. Under the rule as adopted, the producer may only request that the purchaser nominate a price for any *old* gas covered by the contracts the purchaser brought to the bargaining table while the purchaser can make nomination requests with respect to both old and new gas. The applicant alleges that the suggested change would make the parties' bargaining rights more balanced, since the fact that only

[220] Indicated Producers at 15-16.

the purchaser can renegotiate both old and new gas means only it can threaten to terminate the contract with respect to both old and new gas if dissatisfied with the producer's nominated price. The Commission does not adopt the suggested modification. Since new gas is mostly high priced, it would appear that the producer would gain little additional bargaining power by threatening to discontinue sales of that gas. Any benefits to be gained by giving the producer this right would be outweighed by the increased cumbersomeness of the rule. In any event, the Commission believes that the bargaining rights of the parties under the good faith negotiation rule, as adopted, are appropriately balanced.

e. *The Rule That No Contract May Be Renegotiated More Than Once Under The Good Faith Negotiation Rule*

Numerous applicants request various clarifications and modifications to the provision of the good faith negotiation rule as adopted by Order No. 451 that an existing contract may not be renegotiated under the good faith negotiation rule if the parties "have renegotiated the price or any other terms for the sale of any old gas under the contract after July 18, 1986, with or without using the good faith negotiation procedures of this section." [221] First, a number of applicants [222] state that the blanket nature of this provision could cause the unnecessary deferral of routine contract amendments necessary for operational reasons, such as changes in delivery points, quality specifications, and billing procedures. It could also discourage other beneficial amendments such as take-or-pay settlements. This is because a producer would be reluctant to enter into any contract modifications, no

[221] § 270.201(a)(3)(ii), as adopted by Order No. 451.

[222] Indicated Producers at 24; Panhandle and Trunkline at 17; Transwestern at 22; INGAA at 17; Florida Gas at 26; and NGA at 34.

matter how minor, until it had reviewed its contracts with the purchaser to determine the consequences of the loss of its rights under the good faith negotiation rule.

In response to Indicated Producer's emergency motion to clarify § 270.201(a)(3)(i) in order to resolve this problem, the Commission issued an interim order on rehearing on July 17, 1986. In that order, the Commission amended § 270.201(a)(3)(i), subject to further consideration in the rehearing order, to permit parties amending their contract after July 18, 1986, mutually to consent to preserve their rights under the good faith negotiation rule. The Commission continues to believe that this is the correct solution to the problem raised by the applicants and reaffirms the amendment made in the interim order on rehearing.[223]

The purpose of § 270.201(a)(3)(i) as adopted in Order No. 451 was to encourage voluntary renegotiation of contracts in light of the new ceiling price as a substitute for negotiation under the good faith negotiation rule. Without some such provision, purchasers who voluntarily renegotiated contracts with their producers would be subject to requests for further renegotiation under the good faith negotiation rule. In such circumstances, purchasers might well be reluctant to renegotiate their contracts voluntarily. The amendment adopted in the interim rehearing order avoids deterring such voluntary negotiation, since the producer would retain its rights under the good faith negotiation rule only if the purchaser so agreed. At the same time, it accomplishes the goal of permitting parties, if they desire, to make routine or, for that matter, substantial amendments without loss of their rights under the good faith negotiation rule.[224]

[223] This provision now appears in paragraph (a)(4)(i) of § 270.201, as revised.

[224] One party (IPAA), in a motion for reconsideration filed August 13, 1986, requests that the Commission modify the amendment adopted in the interim rehearing order to provide that parties voluntarily amending a contract *retain* their rights under the good faith negotiation rule unless they mutually agree in writing to waive those rights. IPAA claims that the amendment as adopted may permit a purchaser to trick an unsophisticated producer into loss of its rights under the good faith negotiation rule by proposing a minor contract amendment and not informing the producer of the necessity to expressly preserve or lose its rights under the good faith negotiation rule. IPAA also notes that some contract amendments are so minor that parties may not recognize them as renegotiations involving potential loss of rights under the good faith negotiation rule. The Commission declines to adopt IPAA's proposed change in the amendment adopted in the interim order on rehearing. The Commission believes that participants in a regulated industry such as the natural gas industry will become sufficiently familiar with the relevant regulations, and will be able to protect their interests. All persons have constructive, if not actual, notice of all duly published regulations, and as business participants in the natural gas arena, should be aware of possible loss of their rights under the good faith negotiation rule if they amend their contracts. Thus, producers can protect their own interests. However, the Commission is concerned about possible sharp practices by pipelines with respect to small producers hypothesized by IPAA. If such a case presents itself, the Commission may address the matter in the context of that concrete circumstance.

The other solutions to the problem suggested by applicants are not adopted since each would either deter voluntary renegotiation or fail to solve the problem. These suggestions are as follows:

1. Delete section 270.201(a)(3)(i), thereby allowing producers to invoke their rights under the good faith negotiation procedures, regardless of whether they have previously renegotiated existing contracts for the sale of old gas informally. This suggestion would deter voluntary negotiations because it would enable producers potentially to secure economic concessions for the sale of old gas one time through informal, voluntary negotiations and a second time under the formalities of the good faith negotiation rule.

2. Delete the phrase "or any other terms" from the clause in question, so that only informal renegotiations

of the *price* of old gas after July 18, 1986, would bar subsequent resort to the good faith negotiation procedures. This suggestion deters voluntary renegotiation because it would permit producers to exact economic concessions under existing contracts without technically increasing the price of old gas, and later seek price increases under the good faith negotiation procedures.

3. Establish the date when producers may initiate good faith negotiations,[225] rather than July 18, as the date after which informal amendments to existing contracts would preclude subsequent resort to the good faith negotiation procedures. This proposal, however, would continue to stifle minor contract changes after [insert date that is 29 days after publication of this order in the *Federal Register*] since no change could be made after that date without loss of rights under the good faith negotiation ru'e.

Two applicants[226] request clarification that § 270.201 (a)(4)(i)[227] does not operate to deprive producers of their rights under the good faith negotiation rule when there is a price change as a result of a preexisting contract clause. Examples of such contract clauses are price redetermination clauses which call for establishment of a new price at periodic intervals, either by some previously stipulated formula or by negotiation, and inflation adjustment clauses providing for monthly or quarterly automatic price escalations. The Commission believes that when a contract provides for an automatic price change pursuant to a stipulated formula so that no additional negotiations between the parties are required to

[225] Formerly November 1, 1986, now [insert date 30 days after publication of this order in the *Federal Register*.]

[226] Indicated Producers at 27; IPAA at 4.

[227] This provision was in paragraph (a)(3)(i) of § 270.201 in Order No. 451, but now appears in paragraph (a)(4)(i) in § 270.201, as revised.

determine the price, then § 270.201(a)(4)(i) does not operate to deprive the producer of its rights under the good faith negotiation rule. No voluntary renegotiation has occurred. However, if the contract clause requires negotiations to establish a new price, then voluntary renegotiation has occurred and section 270.201(a)(4)(i) does apply. The parties could, of course, mutually agree in writing to preserve their rights under the good faith negotiation rule.

Finally, one applicant[228] contends that § 270.201(a)(3)(i), while prohibiting producers from making nomination requests under the good faith negotiation rule with respect to a contract voluntarily amended after July 18, 1986, unfairly permits purchasers to make nomination requests with respect to such contracts. Although the rule as adopted technically permits the applicant's interpretation, the Commission did not intend to permit purchasers to make nomination requests in such circumstances. Accordingly, the Commission further amends § 270.201(a)(3)(i), now paragraph (a)(4)(i), in order to clarify its intent in this regard.

f. *Abandonment Under The Good Faith Negotiation Rule*

Numerous applicants seek clarification and modification of the provisions of the good faith negotiation rule concerning abandonment. The most significant issue concerning abandonment is the effect of abandonment on a purchaser's take-or-pay obligations under the existing contract. In particular, numerous pipelines, distributor, and consumer representative applicants[229] observe that a

[228] Indicated Producers at 28-29.

[229] PG&E at 7; NI-Gas at 19; SoCal at 8; El Paso at 14, 18; Panhandle and Trunkline at 14; Transwestern at 21; INGAA at 16; Natural and United at 12; Texas Eastern at 24; Transco at 8; ANR and CIG at 24; Florida Gas at 24; Tennessee at 18; UDC at 94; Northwest Central at 55; and AGA at 32.

purchaser at the time of abandonment may, pursuant to its take-or-pay obligation, have paid for gas but not taken it. However, the contract may provide the purchaser a chance to make up that gas over a particular period which has not yet expired. Most applicants request that the Commission require that in such circumstances the producer repay the take-or-pay payment if abandonment occurs under the good faith negotiation rule. Barring that requirement, the applicants desire that the Commission at least require that the purchaser's make-up rights under the contract survive the abandonment. The applicants also state that at the time of abandonment the purchaser may be subject to an accrued obligation to make a take-or-pay payment, but it may not yet have made the payment. Most applicants request that the Commission state that the purchaser is relieved of any accrued obligations to make take-or-pay payments upon abandonment. Applicants contend that the requested clarifications would avoid any inequity resulting from allowing procedures to be paid twice for the same gas, first when they collect take-or-pay payments and second when they sell the gas to a new purchaser after release.

The Commission does not believe it appropriate to establish procedures as to how the parties' take-or-pay obligations are affected when a contract is terminated under the good faith negotiation rule. The Commission believes that resolution of such obligations is part of the renegotiation process and disputes should be settled in accordance with the respective state laws governing the administration of contracts.

Pipeline, distributor, and consumer representative applicants suggest a number of other changes to the abandonment provisions of the good faith negotiation rule to prevent unfairness to them. Several applicants [280] request that the Commission limit the time within which either

[280] *See* El Paso at 15-16, and Arkla at 14-16.

party may exercise its right to abandon sales or terminate purchases. For example, some applicants propose that a party be required to exercise its right of abandonment within one year of the accrual of that right through its rejection of the other party's price nomination. Essentially, the applicants argue that allowing a party to reserve its abandonment right indefinitely would create unnecessary uncertainty for the other party and make future planning by that party difficult. The Commission believes that such a limitation on the parties' abandonment rights would be an unnecessary interference in the marketplace and refuses to adopt it. The primary concern of the applicants is with a pipeline waiting for its producer to abandon sales to the pipeline. While a producer's failure to exercise its abandonment rights for an indefinite time might cause the pipeline some uncertainty, it would also benefit the pipeline since sales would continue at the existing low price until abandonment occurred. Furthermore, given this fact, the Commission believes most producers have a strong incentive to exercise their abandonment rights expeditiously. Therefore, in most cases the problem of the pipeline being placed in indefinite uncertainty should be avoided.

Order No. 451 requires that, before the producers can abandon sales, it must enter into a contract to sell to a third party. In the notice of proposed rulemaking, DOE proposed that the Commission require that the new contract be for a higher price than that nominated by the existing purchaser and be for a term of at least two years. The Commission did not adopt these requirements. Several applicants [281] contend that the Commission should reinstitute these requirements. They contend that the Commission erred in finding these provisions unnecessary since producers are unlikely to sell to another purchaser unless they can obtain a better bargain. They argue that

[281] Northern Distributor Group (NDG) at 14; Northern Natural at 34; ANR and CIG at 16; Northwest Central at 53.

a producer may sell gas to a third party in a short-term agreement at a price less than that nominated by the existing purchaser solely for the purpose of freeing itself from its existing service obligation. Then, when market prices rise, it would be in a position to collect the higher prices. In the interim between expiration of the short-term agreement and higher market prices it might even shut in the gas. Two applicants [232] observe that a sale at a lower price might be more valuable to the producer in any event if the new purchaser agreed to take more volumes and that the new purchaser might well be able to take more than the existing pipeline purchaser.

The Commission continues to believe that the two-year and higher price requirements are unnecessary and unwise. As stated in Order No. 451, those requirements are inconsistent with the Commission's objective of encouraging market-responsive natural gas contracts. The two-year requirement would effectively prohibit market-out clauses for that period. Such clauses have been instrumental in permitting pipelines to reduce their purchased gas costs in recent years. Furthermore, if the Commission required that new contracts be for a higher price, it would also have to prohibit the existing purchaser from nominating any change in the contract other than price. Otherwise, it would be difficult to determine whether the new purchaser's offer was, in fact, worth more to the existing producer, since non-price terms may have a significant effect on the economic value of a bargain. Numerous applicants have stressed the importance of permitting existing purchasers to nominate changes in contract terms other than price as enabling them to renegotiate unfavorable non-price terms in existing contracts.

Even if there is danger that some producers may enter short-term contracts at lower prices to eliminate

[232] ANR and CIG at 17.

their service obligations, the Commission believes that that damper is outweighed by the interest in permitting parties to negotiate new contracts freely without restriction as to the terms they can negotiate. In any event, the Commission continues to believe that producers are unlikely to sell to a third party at terms less favorable than those offered by the existing purchaser. Furthermore, the Commission notes that the increased bargaining power Order No. 451 grants purchasers with respect to higher-priced new gas should enable purchasers to negotiate more effectively to keep the lower-priced old gas. Finally, the producer cannot sell to non-firm sales customers of a non-Order No. 436 pipeline without giving the firm sales customers a right of first refusal. If a producer were to arrange a sale to a third party at an artificially low price solely to eliminate its service obligations, the firm sales customers could benefit from the lower price through exercise of the right of first refusal.

Two pipeline applicants [233] request that the Commission limit the term of any abandonment under the good faith negotiation rule to two years, but provide that the abandonment will become permanent at the end of that period if the parties do not then reach agreement for producers an opportunity to sell to another purchaser in the spot market over the next several years, during which the natural gas surplus deliverability is expected to continue, but will give pipelines an opportunity to protect their historic access to these valuable supplies at the end of that period when the surplus is likely to be largely dissipated. The Commission refuses to adopt this proposal. The good faith negotiation rule, as adopted, gives the purchaser ample opportunity to negotiate to keep the gas when responding to the producer's nomination request. Giving the pipeline an automatic right under the good faith negotiation rule to regain the gas two years later after abandonment would create unnecessary

[233] ANR and CIG at 18-20.

uncertainty.[234] It would also prevent the producer from negotiating a long-term contract with another purchaser in violation of the Commission's goal of maximizing the parties' rights to freely negotiate concerning old gas.

Finally, the same two pipeline applicants[235] request that the Commission state that a pipeline will not be deemed negligent for the loss of gas pursuant to the abandonment provisions of the good faith negotiation rule, even though the pipeline later has to curtail sales because of a shortage of supplies. The applicants state that, because of current market conditions, pipelines may not be able to nominate a high enough price to keep all their old gas. However, in the future, market conditions may change and shortages occur. It would be unfair in such circumstances, the applicants claim, to hold the pipeline negligent for any resulting curtailments. The Commission can make no blanket statement concerning a pipeline's liability for future claims of negligence based on events which have not yet occurred. The Commission assumes that parties will negotiate in good faith based on current and forseeable market and supply conditions. To the extent a pipeline acts prudently and in good faith to do what is in the best interests of its customers, the Commission would not intervene at a later date to hold that pipeline negligent for unforseeable events. The Commission cannot, of course, speculate on how a court would decide any negligence suit brought to it.[236]

Producer applicants also claim that various provisions of the good faith negotiation rule must be modified to

[234] Of course, the pipeline could seek a limited-term abandonment of the type granted in *Southern Natural Gas Co.*, 36 FERC ¶ 61,401 and *Transcontinental Gas Pipe Line Corp.*, 36 FERC ¶ 61,403 if its producers voluntarily agree.

[235] ANR and CIG at 20.

[236] *See* Opinion No. 248, 35 FERC ¶ 61,043, *reh'g denied*, 35 FERC ¶ 61,340 (1986).

prevent unfairness to them. One producer applicant[237] contends that the 30-days notice purchasers must give producers before terminating purchases is too short. The applicant states that because of various factors, including the difficulty of finding purchasers for the relatively small packages of gas which may be released and of arranging transportation to the new purchaser, thirty days is generally too short a time in which to arrange new sales. As a result, the gas is likely to be shut in before a new purchaser is found. Such shut-ins allegedly cause serious operational difficulties for producers. Neighboring wells belonging to other producers may drain the shut-in well. The well might not produce when reopened. The leases may be terminated for cessation of commercial production. The applicant notes that these problems do not arise when the producer abandons sales to the purchaser, since the producer cannot abandon sales until it has arranged for a new sale. The applicant requests that the Commission require that the purchaser give the producer at least 120 days before terminating purchases.

The 30-days notice that Order No. 451 requires purchasers to give producers before terminating purchases is the same notice that the producer must give the purchaser before abandoning sales. Thus, the purchaser has the same time in which to arrange to purchase replacement supplies as the producer has to arrange to sell to an alternate purchaser. The purchaser, too, may have difficulties in arranging to purchase from another producer. Thus, the Commission is reluctant to lengthen the notice the purchaser must give the producer before terminating purchases. However, the Commission does recognize that the producer has one difficulty that the purchaser does not face. The producer must give a pipeline's firm sales customers a right of first refusal before selling to any other purchaser. This process takes up to thirty days it-

[237] Indicated Producers at 9-15.

self after an agreement has been entered into with the alternative purchaser. Therefore, if the producer seeks to sell to a purchaser other than a firm sales customer of the pipeline, it would be virtually impossible for it to arrange the sale within the 30-days notice given by the original purchaser of the termination of purchases. A pipeline receiving notice of abandonment of sales by the producer does not face this problem in arranging to purchase gas from another producer. There is generally no right of first refusal with which it must comply. In light of these facts, the Commission has determined to lengthen the notice the purchaser must give the producer before terminating purchases to 60 days to give more time for the producer to arrange another sale. Section 270.201(c)(2) and (f)(3) are amended accordingly. The notice the producer must give the purchaser will remain at 30 days.

The same applicant[238] also requests that the Commission eliminate the requirement that the producer enter into a contract to sell the gas to a third party before abandoning sales to the original purchaser. The applicant states that this requirement is unfair since there is no comparable requirement applicable to purchasers when they terminate purchases. In addition, the applicant suggests that the producer's ability to abandon sales without having arranged for a new purchaser would give it additional bargaining power to obtain agreement from the purchaser that neither will terminate sales or purchases until both have made alternate arrangements. The Commission rejects this proposal. The purpose of the requirement that the producer contract to sell the gas to another party is to assure that the old gas with its relaively lower price continue to flow to the market-place. There is no similar policy reason for imposing a comparable requirement on purchasers that they arrange to purchase gas from another producer before terminating purchases from the first producer.

[238] Indicated Producers at 14.

Finally, a number of applicants from all segments of the natural gas industry request that the Commission expand the abandonment permitted under the good faith negotiation rule in various ways. First, two pipeline applicants[239] request that the Commission provide for abandonment, at the request of the purchaser, of gas under any contract which has expired and cannot be renegotiated. The applicants state that there are many expired jurisdictional contracts with terms favorable to the producer for which purchasers have been seeking to renegotiate rollover contracts. However, the producers have no incentive to renegotiate such rollover contracts since in the absence of abandonment the purchaser allegedly must continue purchasing gas under the unfavorable terms of the expired contract. The Commission sees no need to modify the good faith negotiation rule to deal with this situation. If the producer requests that the purchaser nominate a price with respect to any contract with a purchaser, the purchaser could seek renegotiation of the expired contract in question.[240] If dissatisfied with the producer's nomination, it could terminate purchases under the contract. If the producer does not make a nomination request with respect to any contract, the only way to deal with the problem raised by the applicants through the good faith negotiation rule would be to permit the purchaser to initiate negotiations under the rule. The Commission refuses to do that for the reasons discussed above at page 124-28.

Second, four pipeline and distributor applicants[241] request that the Commission provide for abandonment when the parties voluntarily agree to it as part of a voluntary renegotiation outside the scope of the good faith negotia-

[239] El Paso at 15-16 and Florida Gas at 20-22.

[240] Since the contract is subject to the Commission's NGA jurisdiction it likely contains some gas priced under section 104 or 106(a).

[241] El Paso at 19; Natural at 11; Arkla at 6; AGA at 40.

tion rule.[242] These applicants contend that such abandonment would be consistent with the Commission's desire to encourage renegotiation. Without providing for such abandonment, if the parties entered into a voluntary agreement involving abandonment, parties would either have to file an individual application or proceed through the good faith negotiation procedures. The Commission refuses to provide the additional abandonment authority to cover this situation. Such abandonment would provide a means for the parties to avoid granting the pipeline's firm sales customers a right of first refusal, unless the Commission also required that the producer grant the firm sales customers a right of first refusal in such circumstances. In any event, there is no significant hardship in requiring the parties either to apply for an individual abandonment or a blanket limited term abandonment of the type granted in *Southern Natural Gas Co.*, 36 FERC ¶ 61,401, or go through the good faith negotiation procedures. The abandonments would likely be granted since unopposed and no fee would be required.

Third, one producer applicant [243] proposes that the Commission provide pre-granted abandonment and transportation rights similar to those provided under the good faith negotiation rule where the parties agree under the good faith negotiation procedures to include a bilateral market-out clause in their contract and one of the parties later terminates purchases pursuant to such a clause. The applicant contends that, without such rights, producers might be reluctant to accept a purchaser's price nomination with a market-out clause, since the purchaser could later exercise that right, and the producer would have lost its rights under the good faith negotiation rule to abandon sales and market the gas elsewhere. The Commission rejects this proposal as unwise in policy and add-

[242] AGA would limit such abandonment to gas previously priced higher than the pipeline's WACOG

[243] Amoco at 7.

ing unnecessary complexity to the good faith negotiation rule. The Commission believes that the parties themselves should negotiate any changes in their contractual relationship. These changes include insertion of market-out clauses and the conditions which must be met for such clauses to be exercised. Therefore, the Commission will not require for example, that pipelines exercising a market-out clause must transport the released gas. A producer with the concerns outlined above should seek the pipeline's agreement not to oppose abandonment and to transport the released gas if the pipeline exercises the market-out clause. Absent such agreement, the producer could refuse the pipeline's price nomination if it includes a market-out clause. In addition, the Commission observes that if the purchaser terminates purchases pursuant to a market-out clause agreed to under good faith negotiation procedures, the producer can seek abandonment from the Commission.

Fourth, one applicant [244] requests that the Commission permit the purchaser to terminate its contract with the producer within 180 days after the producer's rejection of the purchaser's nomination. The applicant expresses concern that, if the purchaser does not have this right, a producer could reject the purchaser's nomination and continue sales indefinitely at the existing price while waiting for gas prices to firm up. The purchaser would be unable to purchase alternative supplies because of its contractual obligation to the producer, but nevertheless could lose the gas sold it by the producer at any time. There is no need to amend Order No. 451 as suggested by the applicant, since purchasers already have the ability to prevent occurance of the situation described by the applicant. If a purchaser did not desire to continue its existing contractual relationship with the producer in the event the producer rejects its price nomination, it may in step 2 request that the producer nominate a price for the gas

[244] NI-Gas at 18.

covered by the producer's step 1 request.[245] It can then either accept the producer's nomination or reject the nomination and terminate purchases.

Finally, another applicant [246] expresses concern that the good faith negotiation rule may permit a purchaser, after rejecting the producer's price nomination requested in step 2, to terminate purchases of all relatively high-cost post-1974 and new gas, without foregoing its contractual right to purchase that gas, while simultaneously continuing to purchase the cheaper pre-1975 old gas. The applicant suggests that the Commission prevent such a situation from arising by providing that the contract is automatically terminated whenever the purchaser discontinues any purchases. The Commission believes that the applicant's concern is unjustified. If the purchaser terminates purchases of any gas, the terms of the existing contract no longer apply to that gas and the producer may sell that gas to another party.[247] It is true that the purchaser's termination of purchases of some gas does not affect the producer's obligation to sell to the purchaser all other gas covered by the contract. However, the producer has the right under the good faith negotiation rule to request the purchaser to nominate a price with respect to any old gas. If dissatisfied with the price nominated, it may abandon sales of that gas. Accordingly, there is no reason to believe that a pipeline would be able to selectively terminate purchases of high-cost gas but require the producer to continue sales of cheap old gas.

[245] *See* discussion *supra* at 151-52.

[246] Amoco at 8.

[247] *See* § 270.201(f)(4) and (5).

g. *Operation of the Good Faith Negotiation Rule With Respect to Multiple Working Interest Owners, Natural Gas Processing Plants, and Advance Payment Contracts.*

Four applicants request that the Commission clarify the operation of the good faith negotiation rule when a number of persons own undivided interests in a lease, yet all the gas is sold under a single contract to the purchaser. Before discussing this issue, the Commission observes that multiple working interest owners generally enter into an operating agreement governing the operation of their lease. The operating agreement names one of their number or a third party as the operator of the lease. In the operating agreement, some working interest owners may authorize the operator to enter into sales contracts on their behalf. These owners thus do not sign the sales contract [248] and are referred to as non-signatory co-owners of the lease. Other working interest owners, however, do not authorize the operator to contract on their behalf, but join in and sign the same contract signed by the operator. These owners are referred to as signatory co-owners of the lease.

One producer applicant [249] requests that the Commission clarify that the operator's nomination request in step 1 affects only its working interest and not those of the non-signatory parties represented by it. This applicant is concerned that an operator's step 1 nomination request might permit the purchaser in step 2 to bring to the bargaining table all its contracts with a non-signatory co-owner, even though that owner did not desire to initiate good faith negotiation with respect to the first contract or any other contract. Another producer applicant [250] requests that the Commission clarify that each

[248] The sales contract may indicate that the operator is acting on their behalf and name them.

[249] Indicated Producers at 27.

[250] Samson at 5-6.

signatory co-owner may proceed separately under the good faith negotiation rule. In addition, it states that, where only one signatory co-owner initiates good faith negotiation the purchaser should not be able in step 2 to bring to the bargaining table the gas of any other co-owner even though that gas is sold under the same contract as the first co-owner's. Two pipeline applicants, however,[251] ask that the Commission state that where there are multiple working interest owners, all must initiate good faith negotiation together or not at all. Otherwise, they claim, pipelines will be faced with difficult operational problems if one co-owner obtains abandonment under the good faith negotiation rule and sells to a third party but other co-owners continue to sell to the pipeline. Another pipeline applicant[252] simply requests clarification how the good faith negotiation rule works when there are multiple working interest owners without taking a position as to how it should work.

The Commission recognizes that the good faith negotiation rule, as adopted in Order No. 451, is ambiguous concerning the rights of multiple working interest owners. Accordingly, it has amended the rule to clarify these rights as explained below.[253] Generally any co-owner of a lease with a direct contractual relationship with the purchaser is treated as having a separate contract with the purchaser and may initiate good faith negotiations separately without implicating the gas of other co-owners. A co-owner who has authorized another to contract on his behalf has no direct contractual relationship with the purchaser and may not initiate the good faith negotiation procedures. Its gas becomes subject to good faith

[251] Panhandle and Trunkline at 16.

[252] Tennessee at 34.

[253] Paragraph (2) (2) (iii) has been included in § 270.201, as revised, and the language now appearing in paragraph (a) (4) has been revised.

negotiation only through the good faith negotiations of the person contracting on its behalf. In other words, its gas is treated as if owned by that person.

Therefore, since each signatory co-owner has a direct contractual relationship with the purchaser, each may initiate good faith negotiations separately. If one signatory co-owner does so, then in step 2 the purchaser may bring to the bargaining table only that co-owner's gas, sold under the contract covered by the initial request or under other contracts containing old gas to which that co-owner is also signatory. Following completion of the three-step nomination procedure, neither the co-owner nor the purchaser may make further nomination requests under the good faith negotiation rule with respect to that co-owner's gas sold under any contract which either brought to the bargaining table. However, the other signatory co-owners may at any time make nomination requests with respect to their gas, and the purchaser will have the same rights with respect to their gas as it did with respect to the first co-owner's.

Non-signatory owners are treated differently since they do not have a direct contractual relationship with the purchaser. Because they have authorized the operators to contract on their behalf, they cannot make nomination requests under the good faith negotiation rule. However, any nomination by the operator must cover the gas of the non-signatory co-owners represented by it, as well as its own gas. When the operator makes a nomination request, the purchaser may in step 2 request that the operator nominate a new price both for its gas and that of any non-signatory co-owners sold under the contract brought to the bargaining table by the operator. The purchaser also may request that the operator nominate a price both for its gas and that of non-signatory co-owners sold under any other contract with the operator containing old gas. This includes the gas of non-signatory co-owners not included in the first contract. However, the

purchaser cannot request that the operator nominate a new price for any other gas of the non-signatory co-owners not covered a contract with the operator.

Following completion of the three-step nomination procedure, neither the operator nor the purchaser may make subsequent nomination requests under the good faith negotiation rule with respect to the gas of the operator and non-signatory co-owners sold under contracts which either the operator or purchaser brought to the bargaining table. However, other signatory co-owners may at any time make nomination requests with respect to their gas and the purchaser will then have the same rights with respect to their gas which it previously had with respect to that of the operator and the non-signatory co-owners. In short, the operator is treated like any other signatory co-owner except that the gas of the non-signatory co-owners on whose behalf it contracted is treated as if owned by the operator.

The operation of these procedures may be illustrated by the following example. Both old and new gas from three leases is sold to a single purchaser under three separate contracts. The operators and other working interest owners of the leases are as shown on the diagram in the margin.[254] Either A, B, or C may initiate good

[254]

Lease 1
Operator = A
Signatory Co-owners = B and C
Non-Signatory Co-owners = D and E

Lease 2
Operator = A
Signatory Co-owner = E
Non-Signatory Co-owners = B, D and F

Pipeline Purchaser

Lease 3
Operator = D
Signatory Co-owner = B
Non-Signatory Co-owners = A and E

faith negotiation with respect to Lease 1. D and E, however, as non-signatory co-owners, may not make nomination requests with respect to that issue.[255] If B, as a signatory co-owner of Lease 1, requests that the purchaser nominate a new price for its old gas sold under the Lease 1 contract, the purchaser may request that B nominate a new price for any of B's gas sold under the Lease 1 and 3 contracts. It may not make a nomination request with respect to any other gas sold under these contracts. Nor may it make a nomination request with respect to B's gas sold under the Lease 2 contract, since B is only a non-signatory co-owner of that lease.

Any price agreed upon between the purchaser and B will apply only to B's gas. The existing price will continue to apply with respect to the other working interest owners' gas. Similarly, if B and the purchaser fail to reach agreement and one abandons sales or purchases, the abandonment will apply only to B's gas.[256] Neither B nor the purchaser any subsequently renegotiate the price of B's gas in Leases 1 and 3 under the good faith negotiation rule. However, all other gas remains subject to renegotiation under the good faith negotiation rule, including B's gas in Lease 2.

[255] Of course, E as a signatory co-owner of Lease 2 could request the purchaser to nominate a price for its gas sold under the Lease 2 contract. If it did that, the purchaser could not make a nomination request with respect to its gas sold under the Lease 1 and 3 contracts, since E is a non-signatory co-owner of those leases.

[256] While abandonment with respect to one working interest owner's gas may cause some operational difficulties, the Commission does not believe these difficulties to be insuperable. Split-stream sales are common. Thus, it should be possible for a working interest owner to sell its gas to a different purchaser than the other working interest owners sell to. In addition, producers can adjust production from wells. Therefore, if a working interest owner fails to find a new purchaser for gas released under the good faith negotiation rule, it should be possible to make the necessary adjustments in production to account for this.

If A, as the operator of Lease 1, makes a nomination request with respect to old gas sold from that lease, it must make the request both with respect to its gas and to that of the non-signatory co-owners D and E. The purchaser may then request A to nominate a new price for A, D, and E's gas sold under the Lease 1 contract. It also may request A to nominate a new price for A, B, D, and F's gas sold under the Lease 2 contract since A is the operator of that lease. The purchaser may not make nomination requests with respect to any other gas sold under the Lease 1 and 2 contracts, since the remaining gas is owned by signatory co-owners not covered by A's original nomination request.[257] Finally, even though A and E are non-signatory co-owners of Lease 3, the purchaser may not request that A nominate a new price for any gas sold under the Lease 3 contract since A is neither the operator nor a signatory co-owner of that lease.[258] Likewise, the purchasers may not request that D nominate a new price for any gas sold under the Lease 3 contract since D was a non-signatory party to the Lease 1 contract nominated by A.

One applicant[259] requests that the Commission describe the operation of the good faith negotiation rule with respect to natural gas processing plants. It states that typically a number of producers sell gas to a procesor under percentage of proceeds contracts and the processor then sells the gas to a pipeline under a separate contract. The applicant asks specifically (1) whether the processor is a first seller that can initiate good faith negotiation and (2) whether the processor's nomination request would trigger a right by the pipeline in step 2 to bring to the

[257] This is true even though the signatory co-owner of Lease 2 is E, one of non-signatory co-owners in Lease 1.

[258] If A were a signatory co-owner of Lease 3, the purchaser could request that A nominate a price for its gas covered by the Lease 3 contract.

[259] Samson at 8-7.

bargaining table all its contracts with the behind-the-plant producers which contain some old gas.

A natural gas processor selling gas under the circumstances described is a first seller of natural gas.[260] Accordingly, it is entitled to request under the good faith negotiation rule that the pipeline nominate a new price for any old gas sold under its contract with the pipeline. The purchaser may in step 2 request that the processor nominate a new price for any gas sold under the contract covered by the processor's request and any other contract with the processor containing old gas. This includes new gas which the processor may buy from a behind-the-plant producer in a percentage of proceeds contract covering only new gas, so long as there is old gas in the processor's contract with the pipeline. However, the pipeline may not make a nomination request with respect to any gas sold by the behind-the-plant producers directly to the pipeline under separate contracts. The pipeline may only reach gas sold under contracts with the person who makes the step 1 request.

The behind-the-plant producers selling to the processor under percentage of proceeds contracts are in a position somewhat analogous to that of non-signatory working interest owners. They may not make a nomination request directly to the pipeline since they have no contract with the pipeline. In addition, they cannot initiate good faith negotiations with the processor, since they lack contractual authority to obtain a higher price from the processor. Their contracts permit them to collect only a particular percentage of what the processor collects from the pipeline. Thus, only the processor can initiate good faith negotiation with respect to the behind-the-plant producers' gas sold to the processor in a percentage of proceeds contract. The behind-the-plant producers will receive from the processor the agreed-upon percentage of

[260] NGPA section 2(21). 15 U.S.C. § 3301(21) (1982). *See also* 18 C.F.R. § 270.202(h) (1986).

whatever price the processor obtains from the pipeline for the relevant gas under the good faith negotiation rule or through voluntary negotiations.

A producer who sells directly to the pipeline but nevertheless has its gas processed in the natural gas processing plant would, of course, be in an entirely different position. Its rights would be more analogous to those of a signatory working interest owner. It could initiate good faith negotiations with the pipeline, and its rights would be unaffected by any good faith negotiation conducted by the processor with respect to its contract with the pipeline.

Finally, two applicants[261] ask that the Commission clarify the operation of the good faith negotiation rule with respect to advance prepayment contracts. Pursuant to the advance payment program, which was terminated in 1975,[262] the Commission permitted pipelines to enter into advance payment agreements with producers. Under such agreements the pipeline would make an advance payment to the producer for use in exploring for gas on specified acreage. The agreement generally dedicated to the pipeline all gas produced from the acreage and provided for repayment of the advance payment. Once gas was discovered, separate sales contracts were entered into between the producer and purchaser. The applicants request that the Commission clarify that where there are outstanding advance payments, when gas is released under the good faith negotiation rule, the producer must repay those amounts. The applicant also states that some gas dedicated to a purchaser under an advance payments contract may have subsequently qualified for NGPA incentive prices and thereby become "new" gas. The applicant requests that the Commission nevertheless treat that gas as old gas for purposes of the good faith negotiation rule,

[261] ANR and CIG at 10-11.

[262] 54 FPC 3046 (1975).

apparently to ensure that purchasers may seek the renegotiation of that gas if the producer initiates good faith negotiation with the purchaser.

The Commission first observes that virtually all advance payments have already been repaid due to the deadlines for repayment the Commission established when it prohibited parties from entering into further advance payment agreements after December 31, 1975. This fact is reflected in current rate filings which show little or no advance payments in rate base. In any event, nothing in Order No. 451 negates or supersedes the requirements in the Commission's various orders concerning the advance payment program that these payments be repaid.[263] Such requirements remain applicable regardless of whether gas is released under the good faith negotiation rule.

Finally, the Commission sees no reason to treat gas dedicated to a purchaser under an advance payment agreement differently from any other gas. To the extent such gas has qualified for NGPA incentive or deregulated prices, it is subject to renegotiation under the good faith negotiation rule to the same extent as any other similar gas.

G. *Right of First Refusal.* In Order No. 451, the Commission provided that, whenever any gas previously sold to a pipeline which has not accepted Order No. 436 is abandoned under this rule, the producer must give that pipeline's firm sales customers a right of first refusal before selling released jurisdictional gas to anyone else. If the producer packages the jurisdictional gas with other gas, the producer must give the firm sales customers a right of first refusal with respect to the entire package. The procedures established by Order No. 451 governing the right of first refusal generally track those governing the right of first refusal which NGPA section 315(b)

[263] FPC Order Nos. 410, 499, and Order Terminating Advance Payment Program, 54 FPC 3046 (1975).

requires sellers to give to existing purchasers of certain gas removed from the Commission's NGA jurisdiction.

In granting a non-Order No. 436 pipeline's firm sales customers a right of first refusal, the Commission observed that those customers may have relied on the pipeline's continued access to low-cost old gas pursuant to the producer's NGA service obligation. The Commission stated that the right of first refusal should enable the firm sales customers to purchase gas released under Order No. 451 at a price approximately equal to or less than the pipeline's WACOG. Thus, the firm sales customers' access to an adequate supply of gas at reasonable cost is protected.

Rehearing Requests. Producers and some large end-users request that the Commission eliminate the right of first refusal given firm sales customers of non-Order No. 436 pipelines. The producer applicants'[264] primary contention is that the right makes difficult the marketing of their gas, since third parties are reluctant to bid for gas when the firm sales customers can take away any favorable deal they obtain. Producers and large end-users[265] also claim that the right unfairly discriminates against new customers and interruptible customers of the pipeline by giving the firm sales customers a preferential right to the gas.

Pipelines, distributors and consumer representatives generally seek expansion of the right of first refusal. Pipelines and some public service commissions from consuming States[266] request that the Commission grant pipelines a right of first refusal superior to their customers'. These applicants state that such a right would recognize

[264] Indicated Producers at 17.

[265] PGC at 4.

[266] ANR and CIG at 14; Arkla at 16; Florida Gas at 23; Tennessee at 22; Northwest Central at 47; California PUC at 29; N.Y. PSC at 16: Kentucky PSC at 3.

the existing contractual commitment of the gas to the pipeline and the pipeline's reliance on that commitment to provide it adequate supplies to serve its customers. At the same time, however, producers could still obtain a market price for the gas. A right of first refusal for pipelines would also better protect the rights of all their customers, since all of them benefit from the pipeline's exercise of its right, whereas only particular firm sales customers benefit from the exercise of the right of first refusal as provided by Order No. 451. Also, a pipeline's right of first refusal allegedly would discourage producers from rejecting the pipeline's price nomination, and then arranging a short-term sale of the gas to a third party at a price lower than that offered by the pipeline, solely for the purpose of permitting it to abandon its service obligation to the pipeline. Some applicants, believing that the existing purchaser can only nominate a price change and not a change in other terms of the contract, state that a right of first refusal for pipelines would also give them an opportunity to obtain gas under the more favorable non-price terms generally offered today than when the pipelines originally purchased the gas. These include market-out rights.

Pipelines, distributors, and consumer representatives also request that the Commission extend the right of first refusal to the firm sales customers of Order No. 436, as well as non-Order No. 436, pipelines.[267] They state that the Commission's rationale for according that right to the customers of non-Order No. 436 pipelines applies equally to the customers of Order No. 436 pipelines. Both sets of customers relied on their pipeline's continued access to the old gas dedicated to it as assuring access to an ade-

[267] Missouri PSC at 9; PG&E at 6; Minnesota DPS at 8; NDG at 15; Cal. PUC at 29; NI-Gas at 21; SoCal at 7; El Paso at 11; INGAA at 17; Missouri PSC at 8; KP&L *et al.* at 29; ANR and CIG at 16; Arkla at 17; AGD at 16; Northwest Central at 52; AGA at 38; APGA at 61.

quate supply of gas at reasonable prices. The applicants disagree with the Commission's contention that the customers of an Order No. 436 pipeline have less need for the right of first refusal since they "could purchase gas from any producer connected to that pipeline and have the gas transported to them." [268] The applicants state that, unlike the Order No. 451 right of first refusal, Order No. 436 does not give firm sales customers any right to purchase gas from producers connected to the pipeline, but only transportation authority for the pipeline. In fact, one applicant contends that the customers of the Order No. 436 pipeline may have a greater need for the right of first refusal since the pipeline may have less ability to nominate a high enough price because its system supply sales will be under such intense competitive pressure from off-system spot gas. Finally, the applicants state that a right of first refusal is a valuable right, since it allows the customer to avoid the time and expense of finding a seller and negotiating from scratch an agreement with it. Rather, the purchaser can exercise the right of first refusal and be relatively confident that it is purchasing the gas at the best available market price. Applicants state that it is unfair to grant such a valuable commercial right to some firm sales customers and not others solely on the basis of whether their pipeline has accepted Order No. 436.

Order No. 451 provides that if several firm sales customers accept a third party offer, the producer has discretion to determine to which it will sell. Some pipelines, distributors, and consumer representatives [269] contend that this right improperly allows the producer to discriminate among the customers. They state a producer will likely choose to sell to large firm customers instead of smaller customers. The larger customers with greater

[268] 51 Fed. Reg. at 22,207.

[269] APGA at 61-62; AGD at 11-12; Missouri PSC at 9; MPC/NASUCA at 23; Arkla at 19-21.

need for gas are a more desirable market. In addition, if the producer is a pipeline affiliate, it may sell to fuel-switchable customers, rather than the pipelines' firm sales customers who must buy the affiliated pipeline's system supply in any event. One applicant [270] proposes that the Commission provide that full requirements firm sales customers shall have priority over all other firm sales customers in the exercise of the right of first refusal.

Commission Response. The Commission rejects proposals by producers and large end-users to eliminate the right of first refusal. The Commission continues to believe that giving firm sales customers of non-Order No. 436 pipelines that right is desirable in order to protect their continued access to adequate supplies at reasonable costs since they relied on the pipeline's continued access to such gas under its service obligation. Thus, the right of first refusal supports the Commission's decision to grant abandonment to producers under section 7(b) of the NGA, if the producer and pipeline fail to reach agreement under the good faith negotiation procedures.

The Commission does not believe that the obligation to give firm sales customers this right unduly burdens producers. NGPA section 315(b) already requires that producers grant a similar right to the existing purchaser for certain gas removed from the Commission's NGA jurisdiction. The producer's obligations under section 315(b) have not had a significant adverse effect on producers' ability to market their gas by discouraging third parties from bidding for the gas. There appears no reason why the right of first refusal obligation imposed by Order No. 451 should have a more significant adverse effect. It is of course true, as pointed out by Indicated Producers,[271] that many pipelines have large numbers of firm sales customers and therefore a producer may, after

[270] Arkla at 20.

[271] at 18.

arranging a sale to a third party, have to give the right of first refusal to many persons. The Commission recognizes that this may place some administrative burdens on the producer. However, the Commission believes that these burdens are mitigated by the requirement that pipelines provide producers with the names and addresses of their firm sales customers. The Commission believes that any burdens on producers from granting the right of first refusal are outweighed by the need to provide firm sales customers the protection afforded by that right.[272] Finally, the Commission rejects the contention that granting the right to firm sales customers unfairly discriminates against new and interruptible customers. As explained above, the firm sales customers may have relied on the pipeline's continued access to old gas pursuant to the producer's NGA service obligation as insuring their access to an adequate supply of gas at reasonable prices. An interruptible customer could not similarly rely on access to the pipeline's old gas since, as an interruptible customer, it was subject to loss of that gas in any event. A new customer obviously never relied on the pipeline's access to the old gas.[273]

[272] Indicated Producers (at 18) also contends that the right of first refusal granted by Order No. 451 may act as a disincentive for pipelines to accept Order No. 436. It states that the present good faith negotiation procedures may "allow non-Order No. 436 transporters and their customers to lock-up old gas while selectively discontinuing the purchase of high-cost supplies." The Commission rejects this argument. Obviously, there are a vast number of factors a pipeline must consider in determining whether it is advantageous for it to become an Order No. 436 pipeline. This one-sentence assertion, unsupported by any analysis, does not convince the Commission that the right of first refusal under Order No. 451 provides an advantage to pipelines rendering them less likely to accept Order No. 436.

[273] The Commission also rejects PGC's alternative proposal for protecting firm sales customers' access to low-cost old gas without giving them a right of first refusal (at 4-7). That proposal is to give the firm sales customers exclusive rights to purchase the gas for thirty days after its release. However, thereafter the producer would be free to sell to anyone else unencumbered by any right of first refusal. The Commission does not believe this proposal gives adequate protection to the firm sales customers. A producer could simply refuse to negotiate with them and then sell to another purchaser after 30 days.

The Commission now turns to the contentions of various applicants that the right of first refusal should be modified. First, the Commission rejects the proposal that pipelines be granted a right of first refusal. Pipelines already have an adequate opportunity to negotiate for continued purchases of the old gas under the good faith negotiation rule, a right that their firm sales customers lack. Furthermore, granting a pipeline a right of first refusal would remove any incentive it has to negotiate in good faith under the good faith negotiation rule. Since that rule requires that in the absence of agreement producers continue sales to the existing purchaser at the existing price until the producer finds another purchaser, a pipeline with a right of first refusal would have every incentive to nominate an unreasonably low price, comfortable in the fact that if the price was rejected and the producer found another purchaser willing to pay a higher market price the pipeline could then exercise its right of first refusal. Thus, as a practical matter, granting pipelines a right of first refusal could largely sabotage the proper operation of the good faith negotiation rule. Furthermore, it is not necessary, as argued by some applicants, to grant this right to pipelines in order to give them an opportunity to obtain relief from unfavorable non-price terms in the existing contracts. As stated in the previous section, the pipeline may in its price nomination propose changes in any other term of the contract.

The Commission also rejects the proposal that the right of first refusal be extended to the firm sales customers of an Order No. 436 pipelines. Those customers do not have

the same need for the right as the customers of a non-Order No. 436 pipeline. Order No. 451 provides the customers of a non-Order No. 436 pipeline only limited transportation rights over that pipeline. They can obtain transportation only of gas formerly sold to the pipeline and released under the good faith negotiation rule. The customers of an Order No. 436 pipeline, by contrast, have much broader transportation rights. They can obtain transportation of any gas whether or not formerly sold to the pipeline or released under the good faith negotiation rule. Thus, there is less need to protect their access to the released old gas formerly sold to the pipeline.

Even assuming applicants are correct that the cost of an Order No. 436 pipeline's system supply may be more likely to increases than that of a non-Order No. 436 pipeline, the customers of the Order No. 436 pipeline are adequately protected by their ability to purchase non-system supply gas and obtain transportation. Finally, while, as some applicants point out, the right of first refusal may be a valuable commercial right, the Commission believes it should grant that right only to those with a need for it. As already discussed, the firm sales customers of an Order No. 436 pipeline do not need that right.

The Commission also refuses to alter the provision that, when more than one firm sales customer exercises its right of first refusal, the producer may in its discretion determine to which it will sell. The Commission is not convinced that the discrimination alleged by various applicants will occur. Any attempt to establish a priority system governing the producer's selection of the firm sales customers to which it will sell would complicate the rule and place additional administrative burdens on the parties. Therefore, the Commission is reluctant to establish such a system.

One applicant[274] requests that the Commission clarify that gas not released under the good faith negotiation

[274] Arkla at 22-23.

rule, and thus not subject to the right of first refusal, may not be included in the agreement with a third party offered to the firm sales customers for their right of first refusal. The applicant is concerned that otherwise a producer and third party might include a large amount of unreleased gas in the third party agreement in order to preclude acceptance by most firm sales customers who have no need for so much gas. The Commission agrees that the offer to the third party must include only gas released under the good faith negotiation rule in order to avoid circumvention in the manner suggested by the applicant. In Order No. 451, the Commission did provide that where the offer to the third party encompasses "non-jurisdictional, as well as jurisdictional gas, the right of first refusal will apply to the entire offer." The non-jurisdictional gas referred to was intended to include only non-jurisdictional gas released under the good faith negotiation rule.

The same applicant also requests that the Commission clarify that where a pipeline and a local distribution company are divisions of the same corporation and no sales contract exists between the two, the local distribution company should nevertheless be considered a firm sales customer of the pipeline division for purposes of the right of first refusal. The Commission agrees. If the two were separate but affiliated corporations, the local distribution company would fall within the definition of firm sales customer. There appears no reason to distinguish between the two situations.

Another applicant[275] requests that the Commission clarify whether a firm transportation customer of the pipeline has a right of first refusal. It does not. That right is limited to firm *sales* customers, those being the customers who relied on the pipeline's access to old gas as ensuring their access to adequate supplies at reasonable cost.

[275] ANR and CIG at 28.

One other applicant[276] requests that the Commission lengthen the 20-day deadline for firm sales customers to accept or reject the third party offer. The applicant contends that the 20-day period provides no opportunity to bargain with the producer. There is no need to provide such opportunity since under the regulations governing the right of first refusal the customer must either accept or reject the offer. Any counteroffer constitutes a rejection. The 20-day response period is the same period provided under the regulations governing the section 315(b) right of first refusal. The Commission is not aware that 20 days has proven too short under section 315(b).

Finally, the Commission addresses the relationship between the existing purchaser's section 315(b) bona fide offer and right of first refusal rights and their customers' Order No. 451 right of first refusal. Section 315(b) requires that when a contract for the sale of NGPA section 102(c), 103(c), or 107(c)(1)-(4) gas which was subject to the Commission's NGA jurisdiction on the day before enactment of the NGPA expires or is terminated, the seller must give the existing purchaser a bona fide offer and right of first refusal before selling to a third party. One applicant[277] claims that the Commission has not made any provision in the good faith negotiation rule for the original purchaser's section 315(b) rights.

It is true that on occasion the existing purchaser may have rights under section 315(b) after release of gas under the good faith negotiation rule. Such rights would, of course, arise only with respect to non-jurisdictional sections 102(c), 103(c), and 107(c)(1)-(4) gas released by the pipeline since that is the only gas to which section 315(b) applies.[278] Where such rights do arise in the context of the good faith negotiation rule, the Commission believes that the producer's nomination of a price for the relevant gas in response to the purchaser's step 2 request constitutes the bona fide offer required by section 315(b), and no additional bona fide offer need be given. However, the producer must still give the existing purchaser its right of first refusal with respect to released section 102(c), 103(c), and 107(c)(1)-(4) gas dedicated to interstate commerce on the day before enactment of the NGPA pursuant to the procedures set forth at § 277.206 of the Commission's regulations. There is, however, no overlap between the section 315(b) and Order No. 451 rights of first refusal. According to the usual practice, the producer must offer only the gas covered by section 315(b) to a third party and present any offer substantially accepted in principle to the original purchaser. In order to comply with § 277.206 the producer must either (1) sell the gas to the third party under the terms of an offer rejected by the original purchaser or (2) sell the gas to the original purchaser.[279] Thus, the gas covered by section 315(b) will never be available for packaging with released jurisdictional gas in a third party offer covered by the Order No. 451 right of first refusal.

[276] APGA at 63.

[277] APGA at 59.

[278] The fact the purchaser terminated the contract would not deprive it of its section 315(b) rights. *See* Order No. 95-A, FERC Stats. and Regs. ¶ 30,690 (1986) at 30,164-65.

H. *Blanket Sales Certification*

In Order No. 451, the Commission promulgated a new regulation, 18 C.F.R. § 157.301, granting producers blanket authorization to sell gas abandoned under the good faith negotiation rule for resale in interstate commerce. Section 157.301 also provides pre-granted abandonment authorization to discontinue sales of gas upon termination of a contract of sale, requires annual reports of sales initiated under the blanket certificate during the preceeding calendar year, and waives rate filling requirements for sales under the blanket certificate.

[279] § 277.204(b).

In their request for rehearing ANR Pipeline Company (ANR) and Colorado Interstate Gas Company (CIG) state that the order appears to require that the abandoned gas *must* be sold for resale in interstate commerce.[280] ANR and CIG assert that such a limitation on the sale of abandoned gas is desirable to assure continued gas supply to the interstate market, and request a clarification from the Commission that the sales of the abandoned gas are so limited. Florida Gas Transmission Company and Transwestern Pipeline Company, on the other hand, argue that the Commission lacks jurisdiction over sales of abandoned gas, except for certain gas from the Outer Continental Shelf (OCS), and seek a Commission declaration that the blanket sales authority granted under the new § 157.301 is only required for such sales, and that abandoned gas can otherwise be sold free from Commission regulation.[281]

None of these applicants correctly stated the effect of abandonment under the good faith negotiation rule. When a producer abandons sales of gas under the rule, the producer is free to sell the abandoned gas to whomever it chooses—whether to an end-user, an interstate pipeline, an intrastate pipeline, or a marketer. A limitation on the sale of abandoned gas to the interstate market, as requested by ANR and CIG, would not be good policy. The Commission sees no need to erect a regulatory barrier to movement of the abandoned gas in response to market forces, or to perpetuate the dichotomy between the interstate and intrastate gas markets that Congress sought to eliminate in passing the NGPA.

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[280] ANR and CIG at 27.

[281] Florida Gas at 12-15; Transwestern at 6-10. Florida Gas and Transwestern's position on this issue is not entirely clear. They may be arguing that the sale of abandoned gas requires certificate authority only if the sale is for resale in interstate commerce, *i.e.*, a jurisdictional sale under the NGA.

Under Section 7(c) of the Natural Gas Act, sales of natural gas for resale in interstate commerce require certificate authority from the Commission. Although section 601(a) of the NGPA removed certain gas from the Commission's NGA jurisdiction, some of which may be released under the good faith negotiation rule, the only released gas which needs and therefore receives abandonment authority under the rule is the gas which has not been removed from the Commission's NGA jurisdiction. Therefore, since the gas which is abandoned under the good faith negotiation rule has not been removed from the Commission's NGA jurisdiction, the sale of such gas for resale in interstate commerce requires NGA certificate authority. The new § 157.301 grants that authority. No certificate authority is needed for any other sales of the abandoned gas or for sales of gas released under the rule which has been removed from the Commission's NGA jurisdiction.

Tennessee Gas Pipeline Company asks if the blanket certificate authority granted by § 157.301 is limited to the first sale of the abandoned gas, or if is it applicable to all subsequent sales of such gas.[282] The blanket certificate authority under § 157.301 applies to any sale of the abandoned gas by the party who received abandonment authority under the good faith negotiation rule. Thus, if abandoned gas has been sold under the authority of § 157.301 and such sales have then been abandoned under § 157.301(b) (pre-granted abandonment), subsequent sales from the same wells or leases may also be made under § 157.301. However, the sales authority of § 157.301 is available only to the first seller (or its successor) who has abandoned sales of the gas under the good faith negotiation rule. A reseller who purchases such gas must have its own certificate authority to sell the gas for resale in interstate commerce.

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[282] Tennessee at 34.

Indicated Producers request the Commission to extend the due date for reports of sales made under the authority of the blanket certificate from March 1 to June 1, asserting that data relating to sales during the latter months of the preceding calendar year will frequently not be available from wells operated by other parties and from gas processing plants until several months after the end of the year.[283] The Commission will extend the due date of such reports until April 1 because it appears that some additional time is warranted. If relevant data is not available to a producer until after April 1, an amended report should be filed.

Kansas Power and Light Company *et al.* (KP&L et al.) argue that the Commission erred by failing to provide a hearing before granting blanket sales authorization under § 157.301 because Section 7(c) of the NGA requires that a hearing be held before issuance of a certificate of public convenience and necessity.[284] The Commission believes that the opportunities afforded in this proceeding for comments, reply comments, public hearing, and requests for rehearing satisfy the hearing requirement of Section 7(c).[285] The Commission has already found that sale of the abandoned gas for resale in interstate commerce by a producer already authorized to sell the gas to an existing interstate purchaser is in the public interest. A requirement of additional hearings on individual applications for authority to sell such abandoned gas would be unnecessary and impose a detrimental regulatory barrier to the continued movement of the gas in the interstate market, especially since producers have the option to sell the abandoned gas elsewhere without a certificate.

[283] Indicated Producers at 32.

[284] KP&L et al. at 18.

[285] *See* Area Rates for the Appalachian and Illinois Basin Areas, 44 FPC 1112 at 1117-1120 and 1132 (1970).

I. *Transportation Authority*

In the final rule the Commission noted the concern of many commenters that pipelines may release gas under the good faith negotiation rule but then refuse to provide transportation to another purchaser. Since a pipeline which can refuse to transport the released gas to an alternative market is in a position to extract unreasonable concessions from the producer to the detriment of the market generally, or even to refuse to negotiate at all, the Commission acted pursuant to its NGA section 5(a) and other statutory authority to prevent such forms of undue discrimination. Accordingly, the Commission provided for the availability of transportation services by pipelines not subject to the open-access provisions of Order No. 436. The transportation service was authorized to any of the releasing pipeline's existing customers (whether firm or interruptible, sales or transportation customers) and to any interconnecting pipeline. This transportation requirement was a condition on the right of the existing pipeline purchaser to terminate purchases of gas from a first seller under the rule, and on the pipeline's right to nominate contracts or volumes of gas other than those nominated by the producer.[286] The limited transportation requirement assures that the pipeline's existing customers, especially firm sales customers, have continuing access to their original gas supply, and that released gas will find a ready market. The Commission noted that the transportation authorization would ensure that the released gas under the new ceiling price would be brought to market, would serve the public convenience and necessity under NGA section 7, prevent undue discrimination in violation of NGA section 5(a), and would thereby lower prices for all consumers and ensure the just and reasonable operation of the new ceiling price.[287]

[286] *See* 18 C.F.R. § 270.201(h).

[287] The Commission found that "failure to condition [avoidance of] the new ceiling price with a transportation provision would

In order to avoid regulatory cost to the pipeline, or unnecessary delay in achieving market-responsive benefits to consumers, the Commission provided a blanket transportation certificate under section 7(c) of the NGA to jurisdictional pipelines not already transporting under Order No. 436.[288] The Commission stated that refusals to transport would be scrutinized carefully under the Natural Gas Act and other applicable law.

Requests for Rehearing. Several pipelines and others have challenged the grant of transportation authority and the transportation requirement in the rule, alleging that these provisions are outside the scope of the Commission's authority under the Natural Gas Act and NGPA.[289] Such applicants characterize the transportation provisions in the rule as an unlawful imposition of common carrier status on unwilling pipelines. Tennessee and KN Energy both devote several pages of their rehearing

cause the new ceiling price to be unjust and unreasonable under section 5(a) of the NGA," insofar as the gas would not be brought to market. 51 Fed. Reg. 22,213 (June 18, 1986). This has been apparently misconstrued by some petitioners as an indication that the new ceiling price is somehow not within the zone of reasonableness absent the transportation requirement. This issue is discussed *infra.*

[288] *See* Order No. 451, Appendix B, for pipelines already indicating intent to provide non-discriminatory transportation at the date of issuance. 51 Fed. Reg. 22,222-23 (June 18, 1986). Pipelines transporting gas under the blanket certificate would not become subject to the open-access requirements of Order No. 436 (18 C.F.R. § 284.8(b) and 284.9(b)) solely by reason of such transportation. Moreover, when requested by the first seller to provide transportation, intermediary pipelines not subject to Order No. 436 open-access requirements, and upstream from the pipeline releasing gas under the rule, may use the separate transportation certificate under section 7(c) of the NGA provided by new § 284.226.

[289] *See, e.g.*, APGA at 63-68; AGD at 12; and ANR and CIG at 5-6; Florida Gas at 6-12; Texas Eastern at 21-22; MPC/NASUCA at 33-34.

applications to a discussion of the legislative history of the Natural Gas Act and the specific language of section 602(b)(2) of the NGPA, to support the proposition that Congress provided that "[n]o person shall be subject to regulation as a common carrier . . . by reason of any transportation . . . authorized by the Commission under section 311(a) of this Act." 15 U.S.C. § 3371(a) (1982).[290] The Commission rejects the argument that Order No. 451 subjects transporters to common carrier regulation. Rather, the transportation requirement is a case-specific-requirement arising out of the particular circumstances of individual pipelines, their certificate obligations, and their duty not to discriminate unduly. Some of the applicants also argue that the transportation authority and new ceiling price are so "of one piece" that if the transportation provisions are held to be legally flawed or to require modification, the new ceiling price would become unjust and unreasonable.[291]

Producers and large industrial consumers of natural gas consider the transportation requirements fully supportable under applicable statutes and Commission precedents, but believe the transportation authorization is too narrow in scope.[292] These applicants urge that the transportation authority be broadened to include intermediate upstream or downstream pipelines if the rule is to have the optimum desired effect of increasing market responsiveness in the natural gas industry.[293] Others suggest that intrastate pipeline transportation should be included,[294] or that the authorized transportation should cover Order No. 436 (open access) pipelines to ensure

[290] Tennessee at 25-28; KN at 20-25.

[291] *See e.g.*, KP&L *et al.* at 9-10; Southern Natural at 12.

[292] Indicated Producers, PGC.

[293] *See, e.g.*, Indicated Producers at 18-24, PGC at 7-9.

[294] IPAA at 5.

that transportation of released gas to new purchasers will be adequate.[295]

Commission Response. We disagree with the applicants alleging that the transportation authority promulgated in Order No. 451 is beyond the Commission's statutory authority. The transportation obligation placed on a pipeline in certain circumstances is supported by statute and case law, as discussed *infra.*

The statutory provisions relevant to the Order No. 451 transportation requirement include NGPA sections 104, 106, and 501,[296] and Natural Gas Act sections 5, 7, and 16.[297] In particular, section 5(a) and its interaction with these other provisions is the central focus of our statutory authority here. Section 5(a) provides that when the Commission finds that

> any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order . . . .

15 U.S.C. § 717d(a) (1982). Certain applicants simply ignore these relevant statutory provisions and instead focus on NGPA section 311.[298] No "common carrier" status has been mandated that would contravene NGPA

[295] Amoco at 3.

[296] 15 U.S.C. §§ 3314, 3316, and 3411 (1982).

[297] 15 U.S.C. §§ 717d, 717f, and 717o (1982).

[298] They state that while section 311(a)(1) of the NGPA permits the Commission to authorize interstate pipelines to provide interstate transportation for local distribution companies and intrastate pipelines, section 602(b)(2) of the NGPA provides that no person shall be subject to regulation as a common carrier by reason of any section 311(a) transportation. However, the transportation policy of Order No. 451 is not predicated on NGPA section 311(a).

section 602(b)(2). Rather, the statutory authority for the essential transportation requirement is found in sections 5(a) and 7 of the Natural Gas Act (NGA), and the general grants of authority in the NGA and NGPA, namely, NGA section 16 and NGPA section 501(a),[299] in conjunction with NGPA sections 104(b)(2) and 106(c).

Some applicants challenge the Commission's power to condition rates under NGPA sections 104(b)(2) and 106(c) and NGA sections 5(a) and 7[300]. As previously emphasized, the Commission's authority here derives from a harmonious interrelationship of NGA section 5 with sections 7 and 16, not from any of them in isolation.

Other applicants acknowledge that the Commission has such authority that may be used to effect access to gas, but argue that the Commission overreached its authority in this instance.[301] These applicants contend that it con-

[299] Section 16 of the NGA provides that "[t]he Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this act." 15 U.S.C. § 717o (1982). Section 501(a) of the NGPA provides that "[t]he Commission . . . is authorized to perform any and all acts (including any appropriate enforcement activity), and to prescribe, issue, amend, and rescind such rules and orders as it may find necessary or appropriate to carry out its functions under this Act." 15 U.S.C. § 3411(a) (1982).

[300] *See, e.g.,* APGA at 64 n.2, ("section 5(a) contains *no express authority to order transportation*") quoting Order No. 436, FERC Stats. & Regs. ¶ 30,665, p. 31,500 (1985) (emphasis in the original); and APGA at 67 ("the Commission cites its conditioning power under NGPA sections 104(b) and 106(c) as statutory authority authorizing it to impose a mandatory transportation obligation . . . [but] cites no legislative history or case law to support this assertion . . . .")

[301] *See e.g.,* Northern Natural at 25 ("To the extent conditions may be attached to an exercise of this authority at all, these conditions may extend only to the regulated entities that are *changing* the rates" (emphasis in original)). Yet, the pipeline ceasing purchase of high-cost gas (or any gas for that matter) under Order

stitutes an abuse of the Commission's discretion to preserve the pipeline purchaser's transportation obligation as part of the good faith negotiation procedures. This is simply a plea to substitute these applicants' judgment of what requirements are in the public interest for the Commission's. This suggestion is rejected because the Commission finds the public interest will be served by the transportation obligation—by the protection of the existing firm customers and the continuance of the flow of gas to the market—and this is integral to the functioning of the rule.[302] The Commission therefore confirms that the rule, *as promulgated*, benefits all participants in the process—consumers, transmission and distribution companies, and producers—and declines to remove the important transportation obligation from releasing pipelines.

KN and others appear to misapprehend the interrelationship between the Commission's authority to establish just and reasonable rates for the transportation and sale of natural gas under NGA section 5, the new just and reasonable ceiling price, and the transportation requirement. Certain language in the order may be the source of the misapprehension. Accordingly, the Commission

No. 451 is effectively changing its rates as well. INGAA at 13-14 takes a slightly different tack. While acknowledging the Commission's conditioning power, INGAA objects to the transportation provision. ("While INGAA disagrees with the assertion by the Commission of an authority to require pipelines to transport gas, we do not doubt generally that the Commission's conditioning authority can lawfully affect the access of deregulated gas into interstate commerce," *citing* FPC v. Transcontinental Gas Corp. 365 U.S. 1 (1961). *See also* Tennessee at 28-30. Tennessee acknowledges that where "the purchaser will have been granted a valuable right . . . the condition may be lawfully attached." Tennessee at 30.

[302] Because transportation is being required pursuant to NGA sections 5, 7, and 16 the rule is changed by deleting the phrase "deemed to agree" and conforming changes are made at §§ 270.201 (h) and 284.225(a) of the regulations.

would note that its statement that the "failure to condition the new ceiling price with a transportation provision would cause the new ceiling price to be unjust and unreasonable under section 5(a) of the NGA,"[303] merely reflects its conclusion that failure to condition avoidance of the new just and reasonable ceiling price on the availability of transportation would cause the new ceiling price to become unjust and unreasonable under section 5(a) of the NGA, insofar as the gas would not be brought to market, the market-responsive benefits of the rule would not be achieved, and the rights of first refusal granted to firm sales customers would be frustrated in operation. Thus, the focus of the transportation provision is not on price *qua* price, but on the essential need to get the gas to market.

There was, in short, no intention to imply that the new just and reasonable ceiling price is outside the "zone of reasonableness" absent transportation. Rather, the price bid for the section 104 or 106 gas, whether up to the new ceiling or below it, will elicit neither the supply nor price response which is the underlying purpose of the rule, if the gas cannot be brought to market. In that case, the new "just and reasonable" ceiling price would be the product of a meaningless exercise, since lacking the ancillary but integral transportation the gas would have much greater difficulty reaching the market, and the benefits of the rule would be commensurately delayed or curtailed. Furthermore, the significant role of the right of first refusal in protecting firm sales customers and consumers would be frustrated directly and completely without the availability of transportation. In the absence of assured transportation, the right of first refusal would be a hollow gesture, because it could not operate without a separate, contestable transportation authorization. Consequently, the Commission would be seriously constrained in its analysis of the just and rea-

[303] 51 Fed. Reg. 22,213 (June 18, 1986).

sonable result without the availability of transportation.[304]

As one court has stated, "'just and reasonable' is merely a term of art for the public interest. . . ."[305] No one should misapprehend any language in Order No. 451 as a statement that the new alternative ceiling price under NGPA sections 104 and 106 is not prescribed in the public interest, and just and reasonable as within the reasonable range of replacement costs. However, newly priced gas must be keyed to the availability of transportation, or the market-responsive benefit of the rule would be lost, and the public interest benefits of the new ceiling price also lost. It is in this sense that the new ceiling is only just and reasonable in conjunction with the accompanying transportation provision.

The facilitation of market-responsive pricing undertaken in Order No. 451 by continuation of the transportation requirement for released gas under the Order No. 451 procedures fully comports with NGA and NGPA goals of adequate supply at a reasonable cost. By requiring a pipeline to continue to provide transportation for released volumes, the pipeline is prevented from unduly discriminating against the existing seller and harming competition by denying a producer transportation and

[304] This distinguishes Order No. 451 from Opinion No. 245 cited by some petitioners in support of recission of the transportation authorization. Felmont Oil Corporation and Essex Offshore, Inc., 33 FERC ¶ 61,333 (1985), *reh'g denied*, 34 FERC ¶ 61,296 (1986), petition for review pending *sub nom.* Consolidated Edison Company of New York, *et al.* v. FERC, D.C. Cir. Nos. 86-1168 *et al.* In Opinion No. 245 the Commission was concerned solely with crafting a proper limited term abandonment so as to protect the rights of all of the several parties in a single abandonment proceeding. Under Order No. 451, however, omission of transportation access would, as discussed in the text, undermine the just and reasonable result.

[305] Pennzoil Co. v. FERC, 645 F.2d 360 at 392 n.27 (5th Cir. 1981).

thereby blocking the benefits of the final rule.[306] The Commission's authority serves as a "first line of defense" against anticompetitive practices.[307]

Nor must the Commission make specific findings for each pipeline; it can exercise its authority under NGA sections 5(a), 7, and 16 generically as it did here.[308] While the seller's side of the wellhead market is workably competitive, considerable evidence suggests that pipeline buyers in the wellhead market have significant market power. Recent studies by EIA[309] and Broadman[310], for example, reach this conclusion.

In the final rule, the Commission is using its section 5(a) authority to require that the blanket transportation authorization established by the rule be utilized by the former pipeline purchaser. This is, in effect, a continuation of the pipeline's existing service obligation to move the gas to market.[311] If a pipeline refuses, without Commission authorization, to *continue to* transport the volumes of gas its facilities were dedicated to transport, the circumstances of this rule, that will be considered an un-

[306] *Cf.* Richmond Power & Light v. FERC, 574 F.2d 610, 623 (D.C. Cir. 1978) (Even though the Commission has no authority to compel transmission service, a different case is presented when the agency acts to prevent undue discrimination or anticompetitive activities).

[307] *See* Gulf States Utilities Co. v. FPC, 411 U.S. 747, 760 (1973).

[308] *See* Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985).

[309] Richard P. O'Neill, James B. Tobin, and Henry Clarius, "Pipeline Mergers and Their Potential Impact on Natural Gas Markets," *Natural Gas Monthly*, Energy Information Administration, February 1986, p. XXVIII.

[310] Harry G. Broadman, "Elements of Market Power in the Natural Gas Pipeline Industry", The Energy Journal, Vol 7, No. 1 (1986), p. 136.

[311] United Gas Pipe Line Co. v. FPC, 385 U.S. 83 (1966); Panhandle Eastern Pipe Line Co. v. FERC, 803 F.2d 726 (D.C. Cir. 1986).

authorized abandonment, separate and apart from the seller's abandonment of the "sale".[312] The pipeline's abandonment must be considered in light of its "obligation, deeply imbedded in the law, to continue service."[313] This is particularly apposite in the context of the good faith negotiation procedures, should the pipeline's existing firm sales customers—those for whose benefit the facilities were certificated and whose rates supported those facilities—exercise their right of first refusal and purchase the released gas. It is also important so that producers will have market access for these certificated gas supplies.

This Order No. 451 transportation requirement then is not "common carriage" as argued by some commenters. Rather, it is a requirement that in particular circumstances the former pipeline purchaser must utilize the blanket transportation authorization granted under the rule, because it is not being relieved of its existing obligation to move the gas, in order to further the Commission's goals under NGA section 5(a) of protecting existing customers, moving gas to market, and achieving the just and reasonable benefits of the rule.

A number of petitioners note the Commission's authority to direct extension or improvement of transportation facilities under NGA section 7(a).[314] Yet Order No. 451 is not grounded on the exercise of NGA section 7(a) authority and thus allegations of exceeding that authority are misplaced. No extension, improvement, or establishment of facilities occurs under Order No. 451. Rather,

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[312] *See, e.g.*, United Gas Pipe Line Co. v. McCombs, 442 U.S. 529 (1979); California v. Southland Royalty Co., 436 U.S. 519 (1978); Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. 137 (1960).

[313] *See* Michigan Consolidated Gas Co. v. FPC, 283 F.2d 204, 214 (D.C. Cir. 1960), *cert. denied*, 364 U.S. 913 (1960).

[314] 15 U.S.C. § 717f(a) (1982). *See e.g.*, Southern Natural at 20-21, *citing Rural Energy Systems, Inc.*, 34 FERC ¶ 61,389 (1986).

existing facilities are likely to be used as they were before, only the business relationships of the parties will have been changed. Accordingly, citations to section 7(a) cases in support of the proposition that the Commission cannot impose transportation obligations are not on point,[315] since under Order No. 451, the Commission is exercising its section 5(a) authority (in conjunction with the other statutory bases discussed herein).

Nor is there any violation of the "able and willing" requirement of NGA section 7(e),[316] as argued by some commenters.[317] If a pipeline elects to bid a lower price than the price which it is obligated to pay under the existing contract and to accept the right to counternominate higher priced old gas (above market levels) in old gas contracts and high-cost gas in multi-vintage contracts for possible reduction, the purchaser signals that it will seek to abandon purchases of that gas if its price terms are not met. If a purchaser is willing and able to purchase and transport gas sold under the producer's certifi-

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[315] *See, e.g.*, Southern Natural at 20-21 *citing* Panhandle Eastern Pipe Line Co. v. FPC, 204 F.2d 675, 679-81 (3rd Cir. 1953); Panhandle Eastern Pipe Line Co., 15 FPC 46, 56-59 (1956), *aff'd sub nom.* Central West Utility Co. v. FPC, 247 F.2d 306, 311 (1957); Consolidated Gas Supply Corp., 28 FERC ¶ 61,350 (1984).

[316] 15 U.S.C. § 717f(e) (1982) ("[A] certificate shall be issued . . . if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed . . . .")

[317] *See, e.g.*, KN at 31 and at 34 *citing* Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378 (1959), FPC v. Texaco, 417 U.S. 380, 394 (1974); Hunt v. FPC 306 F.2d 334, 341 (5th Cir. 1962) *rev'd on other grounds*, 376 U.S. 515 (1964); Northern California Power Agency v. FPC, 514 F.2d 184, 189 (D.C. Cir. 1975). Not only are these cases inapposite from the perspective of the purchaser's abandonment of its purchases, the facilities to be used for the required transportation will be adequate for the service proposed, since they are already being utilized for that purpose. *See* Northern Natural Gas Co., 25 FPC 540, 544 (1961).

cate, (a finding which was made by the Commission in granting the certificate in the first place,) the Commission finds as a matter of law that the purchaser remains "able and willing" to continue transporting gas released under Order No. 451. The pipeline cannot simply refuse to transport the gas and by that act thwart the Commission's exercise of its remedial authority under Sections 5(a) and 16. Nor can the pipeline, by that act, relieve itself of its existing service obligation to transport the gas.

Both the NGA and the NGPA confer general grants of authority to the Commission which have been interpreted broadly by the courts and which support the transportation obligation in the final rule. Under the broad authority granted pursuant to section 501 of the NGPA and section 16 of the Natural Gas Act, the Commission may act to prevent and/or eliminate distortions in the natural gas markets in conjunction with its specific authority under NGPA sections 104(b)(2) and 106(c), and NGA sections 5(a) and 7. Such general grants of authority, of which NGA section 16 and NGPA section 501 are examples, are "not restricted to procedural minutiae, and . . . authorize means of regulation not spelled out in detail, provided the agency's action conforms with the purposes and policies of Congress and does not contravene any terms of the Act.[318] More recently, in *Northern Natural Gas Co. v. FERC*, 785 F.2d 338, 343 (D.C. Cir. 1986), the court held that Congress has granted broad remedial authority in section 16 of the Natural Gas Act to carry out the difficult task of regulating the natural gas industry "under appropriate equitable circumstances" and found it appropriate for the Commission to construe its authority broadly.[319]

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[318] Mesa Petroleum Co. v. FPC, 441 F.2d 182, 187 (5th Cir. 1971), *citing* Niagara Mohawk Power Corp. v. FPC, 379 F.2d 158.

[319] *See also* Consolidated Gas Transmission Corp. v. FERC, 771 F.2d 1536, 1550-51 (D.C. Cir. 1985); Public Service Comm'n of the

The statutes discussed herein (NGA sections 5, 7, 16 and NGPA sections 104, 106 and 501) support the Commission's authority, and those applicants that assert there is no statutory basis for an obligation to continue service to bring the gas to market are in error.

Adjustment to Transportation Authorization

After careful consideration of various commenters' requests,[320] the Commission has determined to expand the transportation authorization in the rule to cover upstream, third-party pipelines which may transport the released gas for redelivery into the system of the former pipeline purchaser. The Commission finds that providing a voluntarily assumable blanket transportation authorization for upstream "feeder" pipelines will serve the twin public interest goals of protecting existing firm customers *and* continuing the flow of gas to the market.

The Commission believes upstream pipelines with available capacity will thus be able to utilize the blanket authorization provided without any regulatory delay or impediment, in order to provide essential transportation services to the same extent they had previously.

The Commission does not believe any blanket transportation authorization is required for interconnecting pipelines downstream of the former pipeline purchaser. Under the final rule, the former pipeline purchaser is already required to deliver the released gas to any interconnecting pipeline, which may continue to transport the gas under such transportation authorization as already exists, or which it may obtain in the future. Interconnecting downstream pipelines thus have the right to purchase

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State of N.Y. v. FPC, 327 F.2d 893, 897 (D.C. Cir. 1964). (Section 16 of the Natural Gas Act held to provide a basis for the Commission to cope with unforeseen problems, and is not confined to procedural regulations, but is a broad grant of authority.)

[320] *See, e.g.*, Indicated Producers at 22-24; PGC at 7-9.

released gas and have it delivered by the releasing pipeline to the point of interconnection. Transportation beyond that point requires separate authorization.

In any situation where a producer or end-user believes it is being unduly discriminated against by any third-party upstream or downstream pipeline with respect to transportation services, it may request the Commission to intercede and remedy the situation through the filing of a complaint pursuant to 18 C.F.R. § 385.206. The Commission intends the transportation authorization under Order No. 451 to be self-implementing, however, and anticipates that such complaints will be rare.

The Commission also denies requests for expansion of the transportation authority to intrastate pipelines, Canadian producers, domestic producers on a non-releasing pipeline system, or to producers without any old gas.[321] This will in no way be unduly discriminatory or harm such entities. Intrastate producers are in large part beyond this Commission's jurisdiction. In any event, consistent with the goal of eliminating disparities between the interstate and intrastate markets, the rule already provides that gas subject to section 106(b) is eligible for the alternative ceiling price if the seller and purchaser so agree. As for Canadian producers, the Order No. 451 program arises out of the old gas ceiling adjustment provided for in NGPA sections 104 and 106 and does not involve Canadian gas, which is free from any constraints as to price under Title I of the NGPA.[322] In the more market-responsive arena provided by the final rule, Canadian producers as well as domestic producers, whether on non-releasing pipelines or not, will find *less* discrimination and preference as gas sales and purchases become more market-driven. Competitive sellers

[321] *See* Independent Petroleum Ass'n of Canada; Westcoast Transmission Co., Ltd. and Westcoast Resources, Inc.; IPAA.

[322] 15 U.S.C. § 3311(b)(4)(A) (1982).

will more easily find an available market, and may obtain transportation under existing procedures.

Indicated Producers request the Commission to clarify that the first seller may be a shipper under the blanket transportation certificate. Indicated Producers state that there is language in the text of the rule indicating that if a first seller requests transportation service, a separate transportation certificate under section 7(c) is necessary,[323] and request a clarification that the first seller, as well as any other shipper, is entitled to receive transportation under the blanket certificate.[324] The Commission grants the requested clarification that the transportation certificate applies to transportation on behalf of the first seller taking part in the good faith negotiation procedures and to any shipper. This clarification is intended to be consistent with the discussion *supra* regarding upstream and downstream third-party pipelines, however. Thus, although the final rule authorizes and requires transportation by the releasing pipeline on behalf of any shipper-purchaser, the blanket transportation authorization extended to upstream, third-party pipelines is available for their voluntary utilization, but their decision to utilize or not utilize the authorization will be subject to review. Similarly, downstream interconnecting pipelines may not unduly discriminate in the use of their existing transportation authorizations, or authorizations they may obtain in the future. In the vast majority of circumstances then, the Commission anticipates that pipelines both upstream and downstream of the former pipeline purchaser will continue to provide transportation services as before, while billing the actual purchaser or contractor of the transportation service instead of the former pipeline purchaser. Only the former pipeline purchaser is *obligated* to provide transportation to any cus-

[323] Indicated Producers at 21.

[324] *Id.*

tomer or interconnecting pipeline under the transportation authorization established in the final rule. Refusals to transport by upstream or downstream pipelines may be unduly discriminatory or otherwise unlawful, however, and will be given close and prompt scrutiny in the unlikely event they occur. Unlike former pipeline purchasers, upstream pipelines have no incentive not to continue transporting as before. Accordingly, the Commission finds no current need to make use of the transportation certificate mandatory for upstream pipelines.

J. *Transportation Rates*

In the final rule the Commission determined that the transportation thereunder would be provided as far as practicable in accordance with the terms and conditions requested by the first seller and its purchaser and at rates promulgated as part of the rule. The rates were based on the § 284.7 concepts established in Order No. 436 and codified in 18 C.F.R. § 284.7. In order to expedite access of existing firm sales customers to released gas, such customers were given a right of first refusal.

Where an existing firm sales customer requested transportation of released gas within its existing firm sales contract demand, its cost for such transportation was not to exceed that which it would have incurred in purchasing the gas from the releasing pipeline. To achieve this result, the rate was based on the appropriate components of the commodity charge in the customer's applicable sales rate schedule, with a credit for volumes of gas transported against any minimum commodity bill obligation. This rate was essentially the commodity sales rate of the pipeline less purchased gas costs. No demand charge or reservation fee was assessed since that would be recovered from the customer as part of its sales demand rate.

Where an existing firm sales cusotmer requested transportation of released gas in excess of its existing contract

demand, or the gas was transported to any pipeline or customer other than an existing customer on a firm basis, the rate was to be based on a transportation rate schedule on file with the Commission that conformed to 18 C.F.R. § 284.7 and either § 284.8(d) for firm service or § 284.9(d) for interruptible service. (Thus, the firm rate could include an appropriate reservation fee since the costs associated with use of capacity for transportation in excess of contract demand are not otherwise recovered from such customers as part of any sales demand rate.) Until such rates become effective, the pipeline must use the rate in one of the pipeline's rate schedules on file with the Commission which the pipeline determines covers service comparable to the transportation service authorized.

Requests for Rehearing. A number of applicants have raised questions regarding the practical application of the transportation rates established in the final rule. They raise questions about the priority of access to the transportation authorized under Order No. 451, and the relationship of transportation priorities under Order No. 436. Pipeline applicants are concerned that they may underrecover some of their costs and ask that their sales obligations be reduced commensurate with volumes released. Consumers and producers are concerned that the transportation authorization be truly effective in bringing gas to market, and that the transportation rates be non-discriminatory so as to achieve this goal. Distribution companies raise technical questions about the determination of transportation rates under Order No. 451, the impact of existing pipeline tariffs, and the interplay with Order No. 436.

Commission Response. The Commission will not grant the requests of several applicants [325] that a pipeline's sales obligations associated with contract demand for a firm

[325] *See, e.g.*, Transwestern at 18-20; Natural and United at 14.

sales customer exercising its right of first refusal under the rule be commensurately reduced, and converted into a firm transportation obligation. Nothing in the rule is intended to unilaterally affect the existing obligations of the pipeline. However, there is likewise nothing in the rule that prevents the pipeline and the firm sales customer from mutually agreeing to changes in existing obligations, or that prevents the pipeline from filing an amendment to its certificate. The Commission recognizes, however, that a firm sales customer who elects to exercise the right of first refusal and have gas transported in lieu of purchasing gas from the pipeline, without a corresponding reduction in the pipeline's sales obligation, should compensate the pipeline for any costs associated with standing by to resume sales service should the firm sales customer subsequently elect to purchase gas from the pipeline rather than transportation service. Accordingly, the Commission shall grant the applicants' request that pipelines be allowed to assess a standby charge where appropriate.[326] The Commission believes that this charge in conjunction with the rate revisions discussed below will ensure that a pipeline receives neither more nor less for providing transportation than it would for providing sales service. A firm customer purchasing transportation service in excess of contract demand under § 284.225(d)(2) of the regulations may already be paying a reservation fee conforming to § 284.8(d).[327] A firm customer purchasing transportation service within contract demand under revised § 284.225(d)(1) should be subject to the same obligation, unless it is already paying a demand charge related to its sales service.

[326] The Commission does not intend to permit such standby charges to be "loaded" with inappropriate costs so as to make the rate so exorbitant that it prevents operation of the rule.

[327] Where a customer purchases firm service under § 284.8(d), that section permits the pipeline to impose a reservation fee or charge on the shipper as a condition for providing such service.

Under § 284.225(d)(1) the Commission intended the pipeline to collect all appropriate transmission, storage, and gathering components in the commodity rate, less purchased gas costs, properly associated with the provision of transportation service. Thus, applicants' assertions of underrecovery, though understandable, are misplaced. Tennessee Gas Pipeline Company expressed the concern, for example, that the credit to the pipeline's minimum commodity bill by volume of gas transported may result in undercollection by the pipeline of the "production cost component" of its sales commodity rate.[328] This is resolved by the Commission clarifying that pipelines may revise their sales rate schedule to recover the costs associated with standing by to serve a firm sales customer who does not reduce contract demand. The standby charge may include production costs if the costs are incurred in providing standby service. Thus, no undercollection would occur. The production cost component should not be included in the transportation rate whether or not transportation is within or in excess of contract demand. If transportation is within contract demand, then a standby charge (associated with sales service) may include production costs. If transportation is in excess of contract demand, then production costs are recovered through the currently effective sales rates. Accordingly, the volumetric credit to the minimum commodity bill in § 284.255(d)(1) is appropriate. The Commission will amend the regulatory text at § 285.225(d)(1) to more clearly follow the § 284.7 concept and include all appropriate transportation cost components, and will allow a pipeline to revise its sales rate schedules to provide a standby service. Thus, the rate for equivalent services paid by distributors, end-users, and others will essentially be the same. This will address the concerns of Process Gas Consumers Group and others that distributors should not be entitled to any more favorable trans-

[328] Tennessee at 32-33.

portation rate than any other shipper.[329] This is consistent with Order No. 436 which established that market-responsiveness is best served by transportation rates that are unbundled and cost-based, whether they apply to existing firm sales distribution customers or to other shippers, and whether within, or in excess of, contract demand.

Under revised § 284.225(d)(1), a pipeline shall file for a rate schedule applicable to firm sales customers which meets the requirements of §§ 284.7 and 284.8(d). To the extent the firm sales customer is currently paying a demand charge related to sales service, the pipeline must waive any § 284.8(d) reservation fee that would otherwise be charged. In addition, the pipeline, as already indicated, may include an appropriate revision to its sales rate schedules to recover costs associated with the pipeline's standing by to serve a firm rate schedule customer who does not reduce its contract demand.[330] Volumes of gas transported will continue to be credited against any minimum bill obligation pursuant to § 284.225(d)(1)(iii). Of course, a firm sales customer and a pipeline that mutually agree to reduce the pipeline's sales obligation, will have to the same extent agreed to reduce any credit required under § 284.225(d)(1)

[329] *See, e.g.*, PGC at 10-12.

[330] As is now the case with the rates in §§ 284.225(d)(2) and (3), until the rate is revised § 284.225(d)(1) becomes effective, the pipeline must use the rate in one of the pipeline's transportation rate schedules on file with the Commission which the pipeline determines covers service comparable to the transportation service authorized under § 284.225(d)(1). The Commission emphasizes that the transportation authorization is self-executing and further that the interim rate requirements for the authorized transportation services do not require any separate regulatory approval by the Commission and do not provide the pipeline with any discretion to avoid or delay providing the transportation services under the interim rate provision. Rather, the pipeline must provide the services using a rate schedule already on file.

(iii). Thus, all customers who request firm transportation will be served under the pipeline's firm transportation rate schedule designed in accordance with § 284.7. Existing firm sales customers will be protected from paying twice for the same capacity by the requirement in revised § 284.225(d)(1)(ii) that pipelines must waive the transportation reservation fee to the extent transportation and sales do not exceed their current contract levels.[331]

AGD poses two questions with respect to the § 284.225(d)(2) transportation rates for service "in excess of contract demand" to existing firm sales customers. AGD first asks how this excess is determined and whether daily, monthly, or annual contract demand is used. Second, AGD states that since the rate can only be determined after the fact (*i.e.*, until the contract demand is determined, however it is measured, one cannot determine if it has been exceeded), a rate so defined "offends the 'filed rate doctrine' and lends itself to retroactive ratemaking."[332]

In response to AGD's first question, contract demand should be determined pursuant to the contractual arrangement of the parties. Although under many of the more recently executed gas purchase contracts, contract demand may be measured daily, whatever time frame the applicable contract provides for determining contract demand shall govern. As to AGD's second question, the determination of whether the purchaser is within or in excess of contract demand is inherently different from retroactive ratemaking, which involves a change in an established rate, not a determination of which rate to apply. The filed rate doctrine simply requires that pro-

[331] "The pipeline must waive the transportation reservation fee to the extent that a customer pays for facilities associated with such transportation service through demand charges under its firm sales rate schedule."

[332] AGD at 14.

viders have a rate on file for different components of service, and that no rate is legal other than the filed rate.[333] The situation under § 284.225(d)(2) is no different from that under current tariffs that require a charge for overruns. The rate is on file for overruns, but the rate cannot be charged until overruns occur, just as the reservation fee in § 284.225(d)(2) cannot be charged unless the firm volumes transported are in excess of the sales contract demand, however measured. Thus the filed rate doctrine is in no way offended by § 284.225(d)(2).

Several applicants raise questions related to the adjustment of existing tariff restrictions to comport with the requirements of Order No. 451. The General Service Customer Group note that its members are generally not allowed to purchase natural gas from any natural gas company other than Panhandle Eastern Pipe Line Company (Panhandle) pursuant to Section 1.9 of the General Terms and Conditions of Panhandle's Tariff.[334] Panhandle also seeks guidance on this situation, and notes that full requirements customers purchasing gas under a rate schedule requiring that all of their gas be purchased from the pipeline, but which then purchase gas released under the good faith negotiation procedures, will be in violation of that rate schedule.

The Commission intends that full requirements tariff provisions are waived to the extent necessary to meet the objectives of Order No. 451. Otherwise the right of first refusal granted to existing firm sales customers in Order No. 451 would be a nullity. For a pipeline with a full requirements or sole supplier clause, the pipeline's

[333] Arkansas Louisiana Gas Co. v. Hall, 453 U.S. 571, 578 (1981); Montana-Dakota Utilities Co. v. Northwestern Public Service Commission, 341 U.S. 246, 251-54 (1951).

[334] General Service Customer Group at 4. Seventy percent of the gas sales in 1985 on Panhandle's system were to General Service Buyers and Small General Service Buyers under Panhandle's full requirements tariff provision.

election to bid less than the highest price permitted under its existing contract necessarily includes an agreement to waive any existing contract and tariff provisions that would prevent an existing firm sales customer from exercising its right of first refusal. No further authorization will be necessary as common sense requires this for the final rule to operate as intended. Accordingly, such full requirements or sole supplier tariff restrictions should be deemed waived with respect to firm sales customers who purchase gas released under the final rule. Since the Commission finds no cost shifting involved in these full requirements customers exercising their right of first refusal and requesting transportation, the Commission finds no basis to justify any rate schedule reclassification because of Order No. 451.

Several applicants ask whether transportation on Order No. 436 pipelines should be made pursuant to Order No. 451. Amoco Production Company suggests that where a pipeline exercises its right under the good faith negotiation procedure to discontinue purchases, it should be permitted to transport that gas for the producer unrestricted by the first-come, first-served provisions of Order No. 436.[335] AGD asks for what time period the transportation service is authorized, and also asks how the service relates to the principle of first come, first-served.[336] AGA requests a similar clarification and asks, in addition, where transportation is provided to an existing customer under Order No. 451 and the pipeline subsequently elects to operate under Order No. 436, is the existing customer given a higher priority than any of the pipeline's other existing customers? AGA asks further whether the existing customer could change its receipt or delivery points after the pipeline opted for Order No. 436, or whether it makes

[335] Amoco at 5-6.

[336] AGD at 13-14. AGD also asks how the Order No. 451 service is to be integrated with existing tariffs and service, which question is addressed, *supra*.

any difference whether the existing customer was receiving the Order No. 451 gas within or in excess of contract demand.[337]

To answer the central question, if an Order No. 451 pipeline subsequently becomes an Order No. 436 pipeline, any shippers under Order No. 451 have priority over new shippers; among the pre-existing shippers, they will likely stand in the same priority vis-a-vis themselves after the open-access election under Order No. 436 as they did before it, but this will depend on how their pre-Order No. 436 relationships are constructed. Transportation of gas released by pipelines already participating under Order No. 436 will be made pursuant to Order No. 436 inasmuch as the Order No. 451 transportation authorization is only available to non-open-access pipelines. In some cases, transportation of the released gas through the releasing pipeline on behalf of any purchaser requesting such transportation will continue until the supply is exhausted, in other cases, upon the expiration of a contract.[338] The priorities that would pertain under Order No. 436 if receipt or delivery points were changed, or if deliveries were made within or in excess of contract demand would continue to apply.

AGA indicates that situations exist where gas that may be released under Order No. 451 is currently being transported through some gathering or short-haul pipeline upstream of the releasing pipeline. AGA suggests that if the releasing pipeline continues to transport the gas through this short-haul pipeline it should be made whole in the event it pays the short-haul pipeline for this transportation service.[339] To respond, since the releasing pipeline will no longer be obliged to purchase the released volumes, it is no longer responsible for the transportation of the released volumes with upstream gatherers or short-haul pipelines. Since it is the existing firm sales customer that, having exercised its right of first refusal, will be purchasing directly from the producer, the firm sales customer (or producer-seller) will have to make its own arrangement with the upstream gatherer for transportation into the releasing pipeline.[340]

Two remaining questions also appear to warrant clarification. ANR Pipeline Company and Colorado Interstate Gas Company (ANR and CIG) ask whether an existing firm *transportation* customer of a releasing pipeline has any rights of purchase or transportation with respect to released gas, and if transportation for such a non-sales customer is to be firm or interruptible.[340a] The brief answer is that only existing firm sales customers have a vested interest in the gas released under the final rule, and only they will have a right of transportation *and* of first refusal thereunder. If they do not exercise their

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[337] AGA at 36-37.

[338] 51 Fed. Reg. 22,213 (June 19, 1986). (Authorization for "transportation will continue until the supply is exhausted, or . . . [until] transportation of such gas ceases upon the expiration of a contract where a pipeline subsequently become subject to Order No. 436.") *Id.*

[339] AGA at 37.

[340] This situation appears related to the issue of whether the blanket transportation should be expanded to cover all jurisdictional transportation arrangements applicable to the gas released, whether upstream or downstream. As discussed in part IV. I., *supra*, the blanket transportation authorization applies to the pipeline releasing gas under Order No. 451 and to any upstream pipeline, and is required to be utilized as a mandatory obligation for the former purchasing pipeline and as a voluntarily assumable blanket authorization for upstream "feeder" pipelines. Transportation through pipelines downstream of the releasing pipeline will be pursuant to section 7(c) certificates or pursuant to Order No. 436. Thus, transportation from the seller to the former pipeline purchaser or to any interconnecting line may proceed without further regulatory approval, with billing of applicable rates now to be made to the parties actually purchasing the transportation services.

[340a] ANR and CIG at 28.

right of first refusal, however, transportation is available to *all* sales and transportation customers pursuant to § 284.225(c), depending on whom the producer seller executes an agreement with.

Florida Gas Transmission Company (Florida Gas) states that the Commission has not expressly limited its rule to take into account factors such as full requirements customers and "transportation rates under existing tariffs which either do not exist or are different from those required under the Commission's rule." [340b] The Commission has already indicated, *supra*, that gas transportation under Order No. 451 operates *pro tanto* to supersede full requirements or sole supplier tariff obligations. Florida Gas' statement regarding transportation tariff rates that do not exist is puzzling. The reference is apparently to the language in §§ 284.225(d)(1), (2) and (3) that requires the pipeline to use as an interim rate "the rate in one of the pipeline's transportation rate schedules on file with the Commission which the pipeline determines covers service comparable to transportation service authorized under this section." [340c] The Commission does not understand Florida Gas' objection and believes that Florida Gas and other pipelines will have sufficiently comparable rates on file until the new § 284.7 rate is established. In particular circumstances, if a pipeline company requires further guidance on this issue, it may request it on a case-by-case basis.

V. OTHER ISSUES

A. *Gas Subject to Rule*

1. *Pipeline and Affiliate Production*

In Order No. 451 the Commission determined that old gas produced by an interstate pipeline or an affiliate of

[340b] Florida Gas at 11.

[340c] *See* former 18 C.F.R. §§ 284.225(d)(2) and (3) and revised § 284.225(d)(4).

an interstate pipeline for the pipeline's system supply would be eligible for the new alternative ceiling price, subject to the requirements of the affiliated entities test set forth in section 601(b)(1)(E) of the NGPA.[341] The Commission noted that such eligibility would be consistent with existing Commission policy under Order Nos. 391 and 391-A.[342] Those orders implemented the Supreme Court decision in *Public Service Commission of New York v. Mid-Louisiana Gas Co.*[343] that interstate pipelines are entitled to have intracorporate transfers of gas from their own wells treated as "first sales" and thus be subject to the pricing provisions of the NGPA. After the issuance of Order No. 451, the United States Court of Appeals for the D.C. Circuit remanded Order Nos. 391 and 391-A to the Commission for reconsideration of whether pipelines are entitled to the same prices for their own natural gas production under section 104 of the NGPA as are independent producers.[344]

APGA requests the Commission to grant rehearing on the applicability of the alternative ceiling price of Order No. 451 to pipeline production and to postpone a final ruling thereon pending its action on the remand of Order Nos. 391 and 391-A.[345] APGA also argues that the potential for abuse of the good faith negotiation procedures between an interstate pipeline and its production

[341] Section 601(b)(1)(E) provides that a first sale of natural gas between an interstate pipeline and its affiliate within the NGPA's maximum lawful price shall be deemed to be just and reasonable if the amount paid does not exceed the amount paid in comparable first sales between persons not affiliated with the interstate pipeline.

[342] 49 Fed. Reg. 33,849 (Aug. 27, 1984); 50 Fed. Reg. 14,374 (Apr. 12, 1985); 18 C.F.R. § 270.203 (1986).

[343] 463 U.S. 319 (1983).

[344] Phillips Petroleum Co. v. FERC, 792 F.2d 1165 (D.C. Cir. 1986).

[345] APGA at 69-71.

division or affiliate supplier is very high, and that it will be difficult for the Commission to "police" such abuses under the affiliated entities test. Therefore, APGA urges the Commission not to apply the alternative ceiling price for old gas to affiliate or pipeline production. In the alternative, APGA urges the Commission to impose special safeguards on renegotiations of the price of affiliate or pipeline production, such as mandatory arbitration or mediation by an impartial third party, auditing of renegotiations by the Commission staff, or spot auditing of renegotiated prices, to assure compliance with the affiliated entities test.[346]

In *Phillips Petroleum Co. v. FERC*, *supra*, the Court noted that prior to the enactment of the NGPA, pipeline production from wells drilled on or before January 1, 1973, (old wells) on leases acquired on or before October 7, 1969, (old leases) was priced on the basis of the actual cost while independent producer rates were based on average costs of production within an area, or nationwide, as was pipeline production from new leases and new wells on old leases. Although the Commission attempted to perpetuate this pricing system after enactment of the NGPA by defining "first sale" to exclude intracorporate transfers of pipeline production from old wells on old leases,[347] the Commission was reversed by the Supreme Court in *Mid-Louisiana*, *supra*. The Commission then issued regulations in Order Nos. 391 and 391-A which applied the same ceiling prices under section 104 to pipeline production as to gas purchased from independent producers, asserting that, "the *Mid-Louisiana* decision requires parity treatment for producer and pipeline production."[348] However, the Court of Appeals in the *Phillips*

[346] APGA at 71-73.

[347] Order No. 58, 44 Fed. Reg. 66,577 (Nov. 20, 1979); Order No. 98, 45 Fed. Reg. 53,091 (Aug. 11, 1980); 18 C.F.R. § 270.203 (1983).

[348] Order No. 391-A, 50 Fed. Reg. at 14,378, 31 FERC ¶ 61,036 (Apr. 10, 1985).

case concluded that the Commission misinterpreted *Mid-Louisiana* as requiring absolute parity of pricing. According to the Court in *Phillips*, section 104 of the NGPA could be interpreted to permit parity of pricing for independent producer and pipeline production, but the Commission would have to offer a reasoned rationale for that interpretation and not base such a conclusion on its erroneous belief that *Mid-Louisiana* mandated such a result.

The Commission must determine on remand of the *Phillips* case whether section 104(b)(1) of the NGPA incorporated the cost-of-service rate for each particular pipeline's production from its old wells on old leases or applied the just and reasonable rates established by the Commission for independently produced gas to such pipeline production. However, in Order No. 451 the Commission established an alternative ceiling price under the authority of section 104(b)(2) and the just and reasonable standard of the NGA, and determined that pipeline production would be eligible for that alternative ceiling price, along with all other old gas, regardless of what the otherwise applicable ceiling price might be under section 104(b)(1). Therefore, the resolution of the issue remanded to the Commission in *Phillips*, a question of interpreting section 104(b)(1), does not affect the Commission's decision in this proceeding that the alternative ceiling price for old gas is available for pipeline production.

The Commission believes that interstate pipelines and their affiliate suppliers should be eligible to receive the alternative ceiling price for old gas established in Order No. 451 for the same reasons and under the same conditions as independent producers. The reasons adduced in Order No. 451 for permitting an increase in old gas prices apply to gas owned by pipelines as well as gas owned by independent producers.

The Commission intends to give special scrutiny to a pipeline's recovery of its costs of purchasing repriced old gas from its own production division or an affiliate and believes that the affiliated entities test will effectively serve to limit a pipeline's recovery of such costs to levels no higher than the costs of comparable purchases from other non-affiliated suppliers. While there are unresolved issues concerning the mechanics of applying the affiliated entities test,[349] there should be no more difficulty in applying that test, when those issues are resolved, to prices paid by a pipeline to its affiliated suppliers or its own production division for repriced old gas than for other categories of gas. It is thus unnecessary to impose any "special safeguards" on these transactions beyond the requirements of the affiliated entities test. Accordingly, the Commission will deny APGA's application to grant rehearing on this issue.

2. *Minimum Rate and Fixed-Price Gas*

The Commission noted in Order No. 451 that contracts for the sale of old gas at the minimum rate or at a fixed rate less than the applicable maximum lawful price would not be eligible for renegotiation under the good faith negotiation procedures because such contracts lack the contractual authority to increase prices necessary to invoke those procedures. Nevertheless, the Commission said that old gas sold under such contracts could be repriced up to the alternative ceiling price if, and only if, the purchaser agreed to pay a higher price after the effective date of Order No. 451.

APGA argues that the alternative ceiling price for old gas should not apply to gas sold under minimum rate or fixed-price contracts, even if the purchaser agrees to pay a higher price, because the producers "hold the trump

[349] *See, e.g.*, Tennessee Gas Pipeline Company, 30 FERC ¶ 63,027 (1985), currently pending before the Commission on exceptions to the initial decision.

cards under the . . . good faith renegotiation procedure . . . [and] will have the ability to extract major concessions from pipelines." APGA also argues that the Commission should not give producers the right to collect increased rates under their lowest-cost minimum rate and fixed-price contracts without giving pipelines a corresponding right to renegotiate price decreases under their high-cost "problem" contracts.[350]

Since the possibility of abandonment under the good faith negotiation procedures is not available for sales under minimum rate or fixed-price contracts, the Commission fails to see how a producer can secure a purchaser's agreement to pay a higher price for old gas subject to such contracts without making some concession of comparable value to the purchaser. In fact, purchasers have the same right to seek voluntary renegotiations of price under their high-cost problem contracts as producers with minimum rate or fixed-price contracts. Accordingly, the Commission sees no reason for disqualifying old gas sold under minimum rate or fixed-price contracts from eligibility for the alternative ceiling price, provided the purchaser agrees to a higher price.

3. *Optional Procedure Certificates*

Tenneco Oil Company and Felmont Oil Corporation seek clarification or rehearing on the applicability of the alternative ceiling price of Order No. 451 to old gas sold under an "optional procedure certificate" issued under the authority of § 2.75 of the Commission's regulations. Nothing in Order No. 451 addresses optional procedure certificates.

In 1972 the Federal Power Commission established a special procedure for certification of new gas sales in interstate commerce at rates in excess of the otherwise applicable maximum lawful rate if the producer waived

[350] APGA at 73-74.

its right to seek future rate increases. Both Tenneco and Felmont hold certificates issued under those procedures under which old gas is currently being sold at contract rates well below current market prices—57 cents per Mcf under a Tenneco contract and 45 cents per Mcf under a Felmont contract. Tenneco and Felmont ask the Commission to clarify or to amend, if necessary, the regulations promulgated in Order No. 451 so they will have an opportunity under the good faith negotiation procedures to renegotiate higher prices for old gas sold under their optional procedure certificates.

In Order Nos. 64 and 64-A,[351] the Commission determined that producers operating under optional procedure certificates could not collect NGPA prices for gas not removed by section 601 of the NGPA from the Commission's NGA jurisdiction. The United States Court of Appeals for the Fifth Circuit upheld those orders.[352] Even if a contract underlying an optional procedure certificate provides contractual authority for escalation to higher rates found just and reasonable by the Commission, rate increases would be barred by the producer's agreement to waive the effect of indefinite price escalator clauses in order to receive an optional procedure certificate.[353] Producers are also barred from increasing their rates except in accordance with the originally certificated contract by the requirement of § 2.75(m) of the Commission's regulations that they waive their rights to make rate filings under section 4 of the NGA. Holders of optional procedure certificates will therefore be ineligible to initiate renegotiations of their underlying contracts under the good faith negotiation rule because such contracts will lack indefinite price escalator clauses, or their

[351] 45 Fed. Reg. 5685 (Jan. 24, 1980); 45 Fed. Reg. 16,171 (Mar. 13, 1980).

[352] Columbia Gas Development Corp. v. FERC, 651 F.2d 1146 (5th Cir. 1981).

[353] *Id.* at 1153; 18 C.F.R. § 2.75(f) (1986).

rights under such clauses will have been waived in order to qualify for the certificate. However, purchasers may voluntarily negotiate with their producers to reprice old gas within the new alternative ceiling price of Order No. 451. If a purchaser agrees to pay increased prices for such gas, a producer may file a petition for a waiver of the regulation's prohibition against rate filings under Section 4 of the NGA.[354]

4. *Existing contracts with area rate clauses*

The Independent Petroleum Association of America (IPAA) notes that the applicability of the good faith negotiation procedures is limited to contracts that provide authority for the first seller to collect a higher price upon establishment by the Commission of a higher maximum lawful price. IPAA argues that this test "leaves open" all of the interpretive issues addressed by the Commission in the Order No. 23 series[355] regarding whether area rate clauses in existing contracts permit the collection of NGPA ceiling prices. IPAA suggests that the Commission declare that a contract with any form of area rate clause is eligible for renegotiation under the good faith negotiation procedures.

The Commission declines to adopt this suggestion, but believes that past proceedings under Order No. 23-B have already resolved most issues of contract interpretation that might arise under the good faith negotiation rule. Order No. 23-B established certain procedures to determine whether particular price escalation clauses authorize increases to NGPA maximum lawful prices. The most commonly discussed price escalation clause, called an "area rate" clause, escalates the price to whatever lawful rate the Commission allows in an area rate proceeding. Thou-

[354] *Id.* at 1160.

[355] Order No. 23, 44 Fed. Reg. 16,895 (Mar. 20, 1979); Order No. 23-B, 44 Fed. Reg. 38,834 (July 3, 1979); Order on Rehearing of Order No. 23-B, 44 Fed. Reg. 48,174 (Aug. 17, 1979).

sands of area rate clauses have been filed by pipelines as part of their "evidentiary submission"[356] and reviewed under the Order No. 23-B procedures. To the extent area rate clauses have been found under those procedures to authorize escalation to NGPA prices, such clauses provide authority for escalation to the alternative ceiling price established by the Commission in Order No. 451. Nevertheless, the Commission cannot say that an existing contract with "any form" of area rate clause will be eligible for renegotiation under the good faith negotiation rule. Whether a contract provides authority to collect a higher price upon establishment by the Commission of a higher maximum lawful price depends on the language of the contract and the intent of the parties. Unresolved disputes concerning such contractual authority may be resolved under the procedures established by Order No. 23-B. However, the argument frequently made in Order No. 23-B proceedings, that area rate clauses authorize escalation to higher rates set by the Commission but not to the NGPA rates set by Congress, will not likely be available to protest the authority of area rate clauses to increase rates to the Commission-set rates of Order No. 451.

B. *Block Billing*

In the final rule the Commission concurred with the view of most commenters that the block billing[357] pro-

[356] *See* 18 C.F.R. § 154.94(j) (1984).

[357] Block billing would require pipelines to bill their customers separately for old gas (Block 1) and new gas (Block 2). Block 1 old gas is gas which was committed to interstate commerce when the NGPA was enacted. This gas is subject to the relatively low price ceilings established by NGPA sections 104, 106(a) and 109. Block 2 new gas is gas whose price has been decontrolled or is subject to the relatively high incentive prices established by other sections of the NGPA. Under the block billing proposal, a pipeline's customers could purchase a specified percentage of the pipeline's Block 1 gas based on their level of purchases during the period 1979-1984.

posal in Docket No. RM85-1-000 (Part D) and the Department of Energy proposal that was adopted in modified form by the final rule were to a large extent mutually exclusive. The Commission indicated that any action on block billing would be deferred to the Docket No. RM 85-1-000 proceedings.

Rehearing Requests. Certain applicants question the Commission's decision to defer action on block billing.[358] Panhandle, for example, asserts that, "[r]ather then taking steps which would require producers to sell gas at market prices, the Commission [in Order No. 451] is attempting to provide higher price levels to producers while otherwise maintaining the contractual status quo . . . ."[359] KP&L argues that the Commission erred "by failing to consider *now* its block billing proposal,[360] and that Order No. 451 does not explain why the block billing proposal does not present an alternative superior to the rule adopted. APGA, for its part, also argues that block billing was a superior alternative for resolving the disparity between old and new gas prices. APGA asserts further that Order No. 451 exceeds the Commission's statutory authority, but block billing would correct the pricing distortions the Commission found to be unjust and unreasonable in the final rule without exceeding the breadth of its statutory authority. APGA states that the Commission has sounded the "death knell" for the block billing proposal.[361]

Commission Response. The Commission believes it is premature for applicants to characterize Order No. 451 as sounding the final tocsin for the block billing proposal. The Commission does intend to review that proposal at a

[358] See, *e.g.*, APGA at 74-78; KP&L *et al.* at 22-24; and Panhandle and Trunkline at 10-11.

[359] Panhandle and Trunkline at 11.

[360] KP&L *et al.* at 22.

[361] APGA at 75.

date after Order No. 451 has an opportunity to operate so that its effects can be gauged. Based on the comments received, the Commission determined that the benefits of Order No. 451 might have been undercut, or made more difficult to measure, had the proposal been put into effect simultaneously with Order No. 451. Moreover, there was evidence that the block billing proposal would merely have shifted inefficiencies to different parts of an already distorted market.[362] It was argued, for example, that the anticipated consumer savings from block billing would not reach consumers because a distributor entitled to a large block of old gas (Block 1) may, by rolling-in Block 2 costs, obscure the true value of the overall supply to its customers, but at a lower level in the distribution chain.[363] After analysis of the evidence compiled in this proceeding, the Commission determined that the most direct means of avoiding market distortion is by eliminating the artificially low gas cushion.

Contrary to the assertions of Panhandle and others, the rule adopted does not maintain the "contractual status quo" but rather offers more of an opportunity for mutuality in negotiations.[364] Under block billing, the pipeline would not be free to offer price changes for old gas, but under Order No. 451 it is free to establish any negotiating posture it wishes, *and* may also seek renegotiation of other contracts. The Commission intends to make

[362] *See* Supplemental Comments of Texaco Inc., filed Feb. 25, 1986, Docket No. RM86-3-000, at 9-10.

[363] *See* J. Kalt "Old Gas Decontrol, FERC's Block Billing for Pipelines, and the Winners and Losers in Natural Gas Policy" (Study sponsored by Natural Gas Supply Association) (Harvard University, Department of Economics 1985) at 15. ("In so far as distribution companies are likely to engage . . . in rolled-in pricing of their own, Block Billing would serve primarily to push the problems of gas pricing one step further down the distribution chain.")

[364] *See* Panhandle and Trunkline at 11.

a final disposition of the block billing proposal in due course, but will do so in Docket No. RM85-1-000 (Part D).

In essence, those applicants objecting to the Commission's deferral of action on block billing would have had the Commission exercise its judgment differently. As with so many issues in this final rule, the Commission could have drawn a line elsewhere—perhaps to adopt block billing concurrently; or perhaps to reject it on the merits now. That the Commission instead wished the processes in Order No. 451 to operate for a time without concurrent implementation of block billing (which many commenters doubted even could be administered concurrently),[365] does not make the Commission's decision unreasonable or outside its authority.[366]

C. *Response to Administrative Law and Procedural Claims*

1. *Transportation and Right of First Refusal Provisions*

Requests for Rehearing. Several applicants argue that the Commission failed to provide commenters with adequate notice and an opportunity to comment on the transportation provisions and the right of first refusal provisions adopted in Order No. 451.[367] Applicants point out that DOE's initial proposal for Order No. 451 contained no mention of transportation for gas released under the

[365] 51 Fed. Reg. 22,210 n.271 (June 18, 1986).

[366] *See* Capital Cities Communication, Inc. v. FCC, 554 F.2d at 1139 (1976). Also, where the Commission exercises its remedial authority, its discretion is "if anything, at zenith." Niagara Mohawk Power Corp. v. FPC, 379 F.2d 153, 159 (D.C. Cir. 1967).

[367] *See e.g.*, ANR Pipeline Company and Colorado Interstate Westcoast Transmission Company, Ltd. and Westcoast Resources, Inc.; KN Energy, Inc.; Northern Distributor Group; American Public Gas Association; and Northwest Central Pipeline Corporation.

good faith negotiation procedures or a right of first refusal. Therefore, they argue that by adopting these provisions, the Commission violates the requirements of the Administraitve Procedure Act (APA) that agencies provide notice, a concise statement of the basis and purpose of the proposed rule, and an opportunity to comment.[368] According to these applicants, the Commission did not have an opportunity to adequately examine the impact of the transportation requirements or the right of first refusal on the wide range of interests that will be affected by the adoption of these provisions. Additionally, applicants argue that persons adversely affected by the blanket transportation and right of first refusal provisions were not afforded an opportunity to file comments and otherwise participate in this rulemaking proceeding. Applicants, therefore, request the Commission to either vacate Order No. 451 because of this legal deficiency, or invite additional comment.

Commission Response. The final rule in this proceeding did not violate the requirements of the APA. Although DOE's proposal and the Commission's notice of procedural schedule preceding Order No. 451 did not specifically provide provisions for transportation and the right of first refusal in connection with the good faith negotiation rule, the Commission was not required to renotice the new provisions and provide for additional comments.

Federal agencies have considerable flexibility under the APA to make changes—even substantial changes—in final rules based on comments submitted during the comment period without renoticing the new provisions.[369] Rulemaking proceedings would never be terminated if

[368] 5 U.S.C. § 553(b) (1982).

[369] *See* Mid-Tex Elextric Cooperative, Inc. v. FERC, 773 F.2d 327, 339 (D.C. Cir. 1985); Pennzoil Co. v. FERC, 645 F.2d 360, 371 (5th Cir. 1981); American Iron & Steel Institute v. EPA, 568 F.2d 284, 293 (3rd Cir. 1977); International Harvester Co. v Ruckelshaus, 478 F.2d 615, 632 n.51 (D.C. Cir. 1973).

the APA were interpreted to require starting the proceeding over again each time the Federal agency modifies a proposed rule in response to comments submitted during the proceeding.[370] As long as the changes represent a logical outgrowth of the initial notice, or develop the rule originally proposed, neither the APA nor the courts require Federal agencies to provide interested persons wiht a new opportunity to comment.[371]

The Commission concludes that the notice for Order No. 451 fairly apprised interested persons of the issues before the Commission. The Commission believes that the public could determine that gas released under the good faith negotiation procedures involved the issues of transportation and protecting the public interest. In fact, a number of commenters raised the transportation issue in their initial comments. Several commenters expressed concern that pipelines might release gas under the good faith negotiation rule, and then refuse to provide transportation for the released gas to other purchasers.[372] These commenters proposed several alternative solutions to the transportation problem. The Commission notes that since these issues were raised in initial comments, an opportunity was provided for response to these comments not only in reply comments,[373] but also during the public hearing.[374]

[370] International Harvester Co. v. Ruckelshaus, 478 F.2d 615, 632 n.51 (D.C. Cir. 1973); Kennecott v. United States EPA, 780 F.2d 445, 459 (4th Cir. 1985).

[371] Connecticut Light and Power Co. v. NRC, 673 F.2d 525, 533 (D.C. Cir.), *cert. denied*, 459 U.S. 835 (1982); *see also*, Chocolate Manufacturers Ass'n of United States v. Black, 755 F.2d 1098, 1102 (4th Cir. 1985).

[372] *See e.g.*, Texaco, Inc. (Texaco); Natural Gas Supply Association (NGPA); Indicated Producers; and PGC.

[373] *See e.g.*, PGC; Indicated Producers; MPC/NASUCA; and Exxon Company.

[374] *See e.g.*, Nicholas J. Bush, NGSA; Charles Jordan, Chevron U.S.A.; Ralph Pearson, Texaco; Ken Notary, Chemical Manufacturing Assn.; William Bennett, Amoco; and Edward Grenier, PGC.

The initial comments, the alternatives proposed in the initial comments, the reply comments, and the testimony presented at the public hearing, made it clear to the Commission that without some provision for transportation added to the final rule, producers could not effectively market the released gas to other customers. Therefore, the Commission concluded from comments submitted that there was no assurance that first sellers could market released gas unless their existing purchasers are operating under the open access transportation provision of Order No. 436.[375] In addition, the Commission concluded that in order for the benefits of Order No. 451 to be realized in terms of both supply and price response, released gas must be marketed in an efficient and effective manner, and therefore promulgated the transportation provisions.

Specifically, the Commission provided limited blanket authority for an existing pipeline purchaser to transport gas released under the good faith negotiation provisions of Order No. 451. In particular, pipelines that release gas must transport any gas released to existing customers or to any interconnecting pipeline, as a condition of the ability of the existing pipeline purchaser to terminate purchases of gas from a first-seller under the Order No. 451. This condition would ensure that the price for released gas will continue to be competitive. Without this condition the Commission concluded that both consumers and pipelines would be restricted in their access to gas supplies released under the rule.

The Commission granted the right of first refusal to provide pipeline's firm sales customers, primarily local distribution companies, the ability to protect their access

[375] As explained more fully in Order No. 451 and elsewhere in this order on rehearing, the Commission found it necessary to include transportation provisions which would ensure availability of transportation service if a pipeline were not operating under the transportation authority of Order No. 436.

to adequate gas supplies at reasonable costs, since they relied on the pipelines continued access to such gas under its service obligations. The right of first refusal was a logical outgrowth of the abandonment provisions of the good faith negotiation rule. In particular, no natural gas company may abandon jurisdictional facilities, or service rendered by jurisdictional facilities absent a finding that gas supplies are depleted, service is unwaranted, or "that the present or future public convenience or necessity permit such an abandonment."[376] The right of first refusal supports the Commission's finding that the abandonments permitted under the good faith negotiation rule are in the present or future public convenience or necessity.

The Commission also recognized that the right of first refusal could not be exercised unless transportation services are available to the customer. Hence, under the final rule, if a pipeline purchaser chooses to terminate purchases of gas, the right of first refusal and the limited transportation authority ensure that the pipeline's existing customers, especially firm sales customers, have a means of keeping the released gas on-system and of getting the gas transported for their use.

The Commission emphasizes that an ongoing dialogue, which began with initial comments filed in this proceeding, continues as the Commission reviews and responds to the petitions for rehearing. The Commission concludes therefore that the adoption of the transportation provision and the right of first refusal were logical outgrowths from the original DOE proposal and the comments thereon filed with the Commission. In addition, the Commission believes that the proposal and comments adequately framed the issues so that commenters were aware of the need to include transportation authority and the right of first refusal in the final rule and had an

[376] 15 U.S.C. § 717f(b) (1982).

adequate opportunity to present their views in reply comments, the public hearing, and on rehearing.

2. *Environmental Impacts.* NEPA requires Federal agencies to prepare an environmental impact statement (EIS) any time their actions will or may have a significant effect on the quality of the human environment.

Rehearing Petitions. Northwest Central and KN Energy argue that Order No. 451 violates section 102 (2)(c) of the National Environmental Policy Act (NEPA).[377] In particular, these applicants argue that the Commission, in violation of NEPA's procedural requirements, failed to consider the environmental impact of raising the price of old gas, which may cause some industrial customers to switch from natural gas to No. 6 fuel oil.

Commission Response. The Commission does not believe that it needs to perform a NEPA review of Order No. 451. An environmental analysis of any major Federal action is premised on the existence of a foreseeable direct connection between the Federal action and an environmental effect. This rulemaking has no such foreseeable direct connection, both because of the nature of the rulemaking and because of the rulemaking's relationship to the natural gas marketplace.

With respect to the nature of the rulemaking, Order No. 451 does no more than allow producers to collect a higher price for old gas or to seek alternative markets for their gas pursuant to the Commission's statutory authority. Order No. 451 does not impose any obligation on any person to purchase or sell old gas. It does not require or authorize any person to construct facilities for these purchases or sales. The order by itself does not directly cause any activities having environmental effects.

[377] 42 U.S.C. § 4332(2)(c) (1982).

With respect to the rulemaking's relationship to the natural gas marketplace, the rulemaking is coincident to a variety of economic conditions and activities which themselves may independently have environmental and economic impacts. These intervening economic conditions and activities include the terms of existing and future natural gas contracts, patterns of industrial, commercial and residential gas consumption, the level of industrial activity, general economic conditions, the price of alternative fuels, the marketability of gas, fuel-switching in relation to conversion costs, and gas conservation efforts. In this instance, the rulemaking cannot be said to have any direct environmental effect whatsoever in light of these intervening considerations. In this connection, Northwest Central's[378] argument, that this rulemaking will affect the environment adversely due to fuel-switching that results from higher gas prices, is inaccurate. It fails to account for the marketability of the gas, the price of alternative fuels, and other intervening conditions that will restrain purchasers from agreeing to unnecessarily high prices for old gas and prevent producers from seeking higher prices or the abandonment of service obligations if the producer and pipeline fail to reach agreement under the good faith negotiation rule.

It is unnecessary for the Commission to undertake a NEPA review in this proceeding because of the diverse considerations that are involved. In fact, the Commission has determined that environmental review under NEPA is not necessary if the variables involved render any environmental consequences unforseeable.[379] The

[378] Northwest Central at 37.

[379] *See* Opinion No. 770, "National Rates for Jurisdictional Sales of Natural Gas," RM75-14, issued July 27, 1976, 56 FPC 509, *reh. denied*, Opinion No. 770-A, 56 FPC 2698 (1976), *aff'd*, American Public Gas Ass'n v. FPC, 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 907 (1978); Order No. 94-C, "Regulations Implementing Section 110 of the Natural Gas Policy Act of 1978 and

Commission believes in the continued validity of this approach. NEPA does not require agencies to engage in environmental impact statements, when the causal relationship between a Federal action and certain environmental effects is remote and conjectural.[380] The Commission believes that this principle applies here. There is no direct connection between Order No. 451 and any changed patterns of consumption or other market effects, much less the environmental effects of any such actions, that would warrant examination of the issue beyond the economic considerations that the Commission has already taken into account.[381]

Establishing Policy Under the Natural Gas Act," RM80-47-002, *et al.*, issued May 24, 1983, FERC Stats. & Regs., Regulation Preambles (1982-1985), ¶ 30,454.

[380] *See e.g.*, Citizen Advocates for Responsible Expansion v. Dole, 770 F.2d 423 (5th Cir. 1985); Save the Bay, Inc. v. United States Corps of Engineers, 610 F.2d 322, 326 (5th Cir. 1980); Sierra Club v. Hodel, 544 F.2d 1036, 1039 (9th Cir. 1976); Citizens Committee Against Interstate Route 675 v. Lewis, 542 F. Supp. 496, 531 (S.D. Ohio 1982). In addition, the regulations of the Council on Environmental Quality, the agency responsible for administering NEPA, also recognize that there are some Federal actions which, by their nature, do not raise the kind of environmental concerns against which NEPA is intended to guard. These are described as actions which do not individually or cumulatively have a significant effect on the human environment. Neither an environmental assessment nor an environmental impact statement is required for such actions. *See* 40 C.F.R. § 1508.4 (1985).

[381] Of particular note are Section IV. D., Supply Response; Section IV. E., Price Response, and Section IV. F., Good Faith Negotiation Rule. Applicants' allegations that the Commission has violated its own regulations by not performing NEPA review are incorrect. The Commission's own regulations require the preparation of an environmental impact statement when the Commission determines that the contemplated activity is a "major federal action significantly affecting the quality of the human environmental." The regulations do not address the situation at issue in this order where the Commission believes that no NEPA review is required. *See* 18 C.F.R. §§ 2.80-2.82 (1986).

D. *Filing Fees*

In Order No. 451 the Commission said there will be no change in applicable rate filing requirements but that filing requirements would be waived for sales of gas abandoned under the good faith negotiation rule and resold under a blanket certificate.[382] Indicated Producers request the Commission also to waive fees applicable to filings made by producers to collect a price for old gas renegotiated under the rule.[383] Absent such a waiver, there will allegedly be a disincentive to voluntary renegotiation of old gas prices with existing purchasers and an incentive to seek abandonment under the good faith negotiation procedures and resell the abandoned gas under a blanket certificate. IPAA asserts that renegotiations under the rule will trigger an "avalanche" of producer rate filings, which the Commission may wish to avoid by amending the regulations to waive rate filings engendered by negotiations under the rule.[384]

Small producers, *i.e.*, producers not affiliated with a major pipeline company and with jurisdictional sales of less than 10,000,000 Mcf of natural gas per year, are exempt from all rate filing requirements under existing regulations to the extent these rates are authorized by contract.[385] The Commission does not believe that rate change filings by large producers resulting from Order No. 451 will impose an unmanageable administrative burden on the Commission's staff or be unduly burdensome to the producers. The filing fee for producer rate changes is $400, an amount that recovers the costs of processing such filings.[386] The Commission does not be-

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[382] 51 Fed. Reg. 22,209-10 (June 18, 1986).

[383] Indicated Producers at 30-31.

[384] IPAA at 4-5.

[385] 18 C.F.R. § 157.40 (1986).

[386] 18 C.F.R. § 381.203 (1986).

lieve that the filing fee will substantially affect a large producer's decision to renegotiate the price with an existing purchaser or seek abandonment under the good faith negotiation procedures. Accordingly, the Commission will not waive the filing requirement or the filing fees for producer rate change filings resulting from renegotiated old gas prices under Order No. 451.

E. *Requests for Stay*

A relatively small number of the applications for rehearing included requests for stay of the effectiveness of Order No. 451. On July 28, 1986, the Commission denied the requests of KN Energy, Inc. and certain Florida Cities for an immediate stay of the effectiveness of the final rule.[387] At that time the Commission noted that several other applicants had requested a stay pending judicial review, in the event their applications for rehearing were denied. These applicants included the American Public Gas Association (APGA), the Interstate Power Company, the Northern Distributor Group, and Laclede Gas Company. On December 5, 1986, AGA, APGA, AGD and UDC also filed a joint petition for a stay of the effective date of the good faith negotiation procedures. The Commission has evaluated the arguments for rehearing.

In reviewing requests for stay, the Commission applies the standard set forth in the Administrative Procedure Act, 5 U.S.C. § 705 (1982), *i.e.*, if the Commission finds that "justice so requires." [388] For essentially the reasons

[387] 51 Fed. Reg. 27,529 (Aug. 1, 1986), 36 FERC ¶ 61,102 (1986).

[388] *See, e.g.*, Arkansas Louisiana Gas Co., 23 FERC ¶ 61,324 (1983). The applicants have framed their arguments under the four factors listed in Virginia Petroleum Jobbers Ass'n. v. FPC, 259 F.2d 921 (D.C. Cir. 1958), and Metropolitan Area Transit Comm. v. Holiday Tours, Inc., 559 F.2d 841 (D.C. Cir. 1977). Even using those factors, the Commission believes the requests for stay should be denied. As discussad more fully in the text of this order, the Commission has exercised its broad jurisdiction over the parties

set forth in its order of July 28, 1986,[389] the Commission finds that justice does not require postponing the effective date of Order No. 451, and the requests for stay not heretofore disposed of are therefore denied.

F. *Effective Date and Paperwork Reduction Act Statement*

The amendments to the Commission's regulations adopted in this order on rehearing will become effective on [insert date 30 days after publication of this order in the *Federal Register*]. The effectiveness of the date on which a producer is permitted to make a nomination request under the good faith negotiation rule in Order No. 451 (18 C.F.R. § 270.201) is further postponed until [insert date 30 days after publication of this order in the *Federal Register*].

The information collection provisions in this rule are being submitted to the Office of Management and Budget

and contracts affected by Order No. 451 in a balanced way that cannot fairly be characterized as *ultra vires*. Assertions of irreparable harm are also unfounded. Even if the courts modify Order No. 451 on review, only money adjustments need be made to make parties whole. Economic damages, even if they do derive from agency action, are insufficient to constitute "irreparable harm." *See, e.g.*, Wisconsin Gas Co. v. FERC, 758 F.2d 669 at 674 (D.C. Cir. 1985), *citing* Virginia Petroleum Jobbers Ass'n., 259 F.2d at 925. Moreover, Order No. 451, by providing a significantly greater degree of market-responsiveness in the gas markets will benefit a broad spectrum of the public. A delay in implementation will harm this broad spectrum of parties which includes consumers, end-users, local distribution companies, producers, marketers and pipelines generally. On balance, the long-term public interest benefits of the rule to consumers and to the industry as a whole outweighs any initial detriment to those few entities that benefited from a distorted market. This militates against any stay of the rule and instead underscores the need for its prompt implementation.

[389] Order Denying Petitions for Stay of Order No. 451, Docket Nos. RM86-3-006, RM86-3-062, 36 FERC ¶ 61,102, 51 Fed. Reg. 27,529 (Aug. 1, 1986).

(OHB) for its approval under the Paperwork Reduction Act [390] and OMB's implementing regulations.[391] Interested persons can obtain information on these information collection provisions by contacting the Federal Energy Regulatory Commission, 825 North Capitol Street, N.E., Washington, D.C. 20426 (Attention: Ellen Brown (202) 357-8272). Comments on the information collection provisions can be sent to the Office of Information and Regulatory Affairs of OMB, New Executive Office Building, Washington, D.C. 20503 (Attention: Desk Officer of the Federal Energy Regulatory Commission).

List of Subjects:

18 C.F.R. Part 270

Natural gas
Price controls
Reporting and recordkeeping requirements

18 C.F.R. Part 284

Continental shelf
Natural gas
Reporting and recordkeeping requirements

In consideration of the foregoing, the Commission is amending Parts 270, and 284, Title 18, *Code of Federal Regulations* as set forth below.

By the Commission.

[SEAL]

/s/ Kenneth F. Plumb
KENNETH F. PLUMB,
Secretary.

[390] 44 U.S.C. §§ 3501-3520 (1982).

[391] 5 C.F.R. § 1320 (1986).

1. The authority citation for Part 270 continues to read as follows:

Authority: Natural Gas Act, 15 U.S.C. 717-717w (1982); Department of Energy Organization Act, 42 U.S.C. 7101-7352 (1982); E. O. 12,009, 3 C.F.R. 142 (1978); Natural Gas Policy Act of 1978, 15 U.S.C. 3301-3432 (1982).

2. Section 270.201 is amended by revising paragraphs (a), (b)(1)(i), (b)(3), (c)(2), (d), (e)(1), and (f)(3) to read as follows:

§ 270.210 Good faith negotiation procedures.

(a) *Applicability, definitions, and general rules.* (1) This section applies to requests for renegotiation of the price of old gas sold under an existing contract.

(2) For purposes of this section:

(i) "Old gas" means natural gas which, if sold, would be subject to a maximum lawful ceiling price under section 104 or 106(a) of the NGPA.

(ii)(A) "Existing contract" means a contract in effect on July 18, 1986, or an expired contract pursuant to which sales of natural gas are continuing on that date under the service obligation of a certificate of public convenience and necessity, that includes the sale of any old gas and provides authority for the first seller to collect a higher price upon establishment by the Commission of a higher maximum lawful price.

(B) An existing contract includes the sale of old gas if, on July 18, 1986, the contract encompasses the sale of any gas that has not been abandoned under section 7(b) of the Natural Gas Act and which, if sold, would be priced as old gas, whether or not any old gas is sold on that date.

(iii) The terms "first seller" and "party to a contract" include:

(A) an owner of a working interest in an oil or gas lease that has a direct contractual relationship with a purchaser for a "first sale" of gas, as defined in section 2(21) of the NGPA; and

(B) an operator of an oil or gas lease that has a direct contractual relationship with a purchaser for a "first sale" on behalf of any owner of a working interest in the lease that does not have such a relationship.

(3)(i) Any existing contract under which old gas is sold may be renegotiated or amended at any time to provide for a price up to the alternative maximum lawful price under § 271.402(c)(7)(i) of this chapter without using the good faith negotiation procedures.

(ii) A price for old gas that exceeds the otherwise applicable maximum lawful price under § 271.402 of this chapter may be collected under an existing contract only if the first seller and purchaser agree upon a price up to the alternative maximum lawful price under § 271.402 (c)(1)(ii) in accordance with this section.

(4) A party to an existing contract may not request a nomination of a price under the provisions of this section for any gas sold under the contract, if that party:

(i) and the purchaser or first seller have renegotiated the price or any other terms for the sale of any old gas under the contract after July 18, 1986, without using the good faith negotiation procedures, of this section, and have not agreed in writing to preserve their rights under this section;

(ii) has previously requested nomination of a price under paragraph (b)(1) of this section for any gas sold under the contract; or

(iii) has been requested under this section to nominate a price for any gas sold under the contract, and the last date has passed under paragraphs (b)(2) or (b)(3) of this section to request the other party to nominate a price for gas sold under the contract.

(5) Any request for nomination of a price under this section, any nomination of a price in response to such a request, and any notice of abandonment of sales or termination of purposes under this section must be sent by U.S. mail, return receipt requested.

(6) Any deadline under this section for requesting a nomination of a price, or for nominating a price in response to such a request, may be extended by mutual agreement of the parties in writing.

(7) A party nominating a price may propose a change in any other term of the existing contract, and for purposes of this section, the terms "nominated price" and "nomination" may include such a proposed change.

(b) *Requests for negotiation and nomination of price.*

(1)(i) At any time after (insert date 30 days after publication of this order in the *Federal Register*) a first seller may request the purchaser to nominate a price at which the purchaser is willing to continue buying old gas under any existing contract by submitting a written request to the purchaser, and may specify the wells or category of wells under each contract for which the first seller requests a renegotiated price.

* * * *

(3) Within 30 days after receiving a request from a purchaser for nomination of a price for any gas under a contract that is not named in the first seller's request and that includes the sale of any old gas, the first seller may request the purchaser to nominate a price at which the purchaser is willing to continue buying any old gas under that contract, including old gas for which the purchaser has requested a nomination of price by the first seller, by submitting a written request to the purchaser.

* * * *

(c) *No response to request for nomination.*

(1) * * *

(2) If the first seller does not nominate a price in writing within 60 days after receiving the purchaser's request for nomination of a price, the purchaser may terminate its purchases of all or part of the gas named in its request for nomination at any time upon 60 days written notice to the first seller.

(d) *Purchaser's nomination of highest price.* If the purchaser nominates in writing the highest price to which an existing contract price could escalate with the purchaser's agreement under § 271.402(c)(7)(ii) of this chapter, and the purchaser does not propose a change in any term of the contract, sales must continue at the nominated price under the terms of the existing contract.

(e) *Purchaser's nomination of lower price; first seller's options.* (1) If the purchaser nominates in writing a price less than the highest price to which the existing contract price could escalate or proposes a change in any other term of the contract, the first seller must accept or reject the nominated price in writing within 30 days after receiving the nomination. If the first seller does not accept the purchaser's nominated price in writing within 30 days, the nominated price is deemed rejected.

* * * *

(f) *First seller's nomination of price; purchaser's options.*

* * * *

(3) If the purchaser rejects the nominated price, the purchaser may at any time terminate its purchases of all or part of the gas named in its request for nomination upon 60-days written notice to the first seller.

* * * *

3. In section 270.201, the first sentence of paragraph (h) is amended by removing the phrase "is deemed to have agreed to" and inserting in lieu thereof the word "must".

4. The authority citation for Part 284 continues to read as follows:

Authority: Natural Gas Act, 15 U.S.C. 717-717w (1982); Natural Gas Policy Act of 1978, 15 U.S.C. 3301-3432 (1982); Department of Energy Organization Act, 42 U.S.C. 7107-7352 (1982); E. O. 12,009, 3 C.F.R. 142 (1978).

5. In section 284.225, paragraph (a) is amended by removing the phrase "is deemed to have agreed to" and inserting in lieu thereof the word "must".

6. The table of contents for Part 284 is amended by adding a new section to Subpart K to read as follows:

PART 284—CERTAIN SALES AND TRANSPORTATION OF NATURAL GAS UNDER THE NATURAL GAS POLICY OF 1978 AND RELATED AUTHORITIES

* * * *

SUBPART G—BLANKET CERTIFICATES AUTHORIZING CERTAIN TRANSPORTATION BY INTERSTATE PIPELINES ON BEHALF OF OTHERS AND SERVICE BY LOCAL DISTRIBUTION COMPANIES

Sec.

* * * *

284.226 **Transportation by interstate pipelines upstream of pipelines releasing gas under the good faith negotiation procedures**

7. Section 284.225 is amended by revising paragraph (d) to read as follows:

* * * *

§ 284.225 **Transportation by interstate pipelines of gas released under the good faith negotiation procedures.**

(d) *Transportation rates.*

(1) *Transportation service within contract demand.* If a pipeline provides transportation of gas to an existing

customer under this section and, as a result, the total volumes of gas sold and transported to that customer on a firm basis do not exceed existing firm contract demand by that customer, the pipeline:

(i) Must base its transportation rate for such gas on the rate in a transportation rate schedule on file with the Commission that conforms to § 284.7 and § 284.8(d);

(ii) must waise any transportation reservation fee to the extent that a customer pays for facilities associated with such transportation service through demand charges under its firm sales rate schedule;

(iii) must credit the volumes of gas transported against any minimum commodity bill obligation; and

(iv) may recover costs, on an Mcf or MMBtu basis, associated with standing by to serve a firm sales rate schedule customer that does not reduce its contract demand, if the pipeline revises its sales rate schedules on file with the Commission.

(2) *Transportation service in excess of contract demand.* If a pipeline provides transportation of gas to an existing customer under this section and, as a result, the total volumes of gas sold and transported to that customer exceed existing firm contract demand to that customer, the transportation rate for such gas must be the rate in a transportation rate schedule on file with the Commission that conforms to § 284.7 and either § 284.8-(d) for firm service or § 284.9(d) for interruptible service.

(3) *Transportation service for other customers.* If a pipeline provides transportation of gas under this section to any pipeline or customer other than an existing customer on a firm basis, the transportation rate for such gas must be the rate in a transportation rate schedule on file with the Commission that conforms to § 284.7 and either § 284.8(d) for firm service or § 284.9(d) for interruptible service.

(4) *Interim rates.* If a pipeline does not have a transportation rate schedule on file with the Commission that conforms to § 284.7 and either § 284.8(d) for firm service of § 284.9(d) for interruptible service, the pipeline must file such a rate schedule within 60 days after first providing transportation service under this section. Until such a rate schedule becomes effective, the pipeline must provide the transportation service using the rate in one of the pipeline's transportation rate schedules on file with the Commission which the pipeline determines covers service comparable to transportation service authorized under this section.

* * * *

8. Part 284 is amended by adding a new § 284.226 to read as follows:

284.226 Transportation by interstate pipelines upstream of pipelines releasing gas under the good faith negotiation procedures

(a) *Applicability.* This section applies to any upstream interstate pipeline that is not subject to the nondiscriminatory access provisions of § 284.8(b) or § 284.9 (b) of this chapter and that provided transportation of gas immediately prior to its release by any interstate pipeline due to termination or abandonment under the good faith negotiation procedures in § 270.201 of this chapter. Such upstream pipelines were those authorized under a certificate of public convenience and necessity to transport natural gas, prior to the release of that gas due to termination or abandonment under § 270.20(c), (e), or (f) of this chapter, along any line between the wellhead and a pipeline that must transport the gas under § 270.201(h) of this chapter.

(b) *Blanket Certificate.* Such upstream interstate pipelines are granted a blanket certificate of public convenience and necessity that authorizes transportation of natural gas released due to termination or abandonment under § 270.201(c), (e) or (f) of this chapter on

behalf of any shipper to any interstate pipeline releasing gas under § 270.201 of this chapter, under the same terms and conditions as previously provided to the releasing pipeline.

(c) *Transportation rates.* The rates charged by such third-party, upstream pipelines for transportation under this section shall be identical to the rates charged under any pre-existing transportation authorization for the same service previously provided to the releasing pipeline.

(d) *Reporting requirements.* An interstate pipeline that transports gas under the certificate granted by this section is subject to the reporting requirements of § 284.223(f).

FERC ORDER 451-B

52 F.R. 21669 (June 9, 1987).

18 CFR Parts 270 and 284

[Docket Nos. RM86-3-069—077; Order No. 451-B]

Ceiling Prices; Old Gas Pricing Structure

Issued June 3, 1987.

AGENCY: Federal Energy Regulatory Commission, DOE.

ACTION: Order Granting Rehearing in Part, Denying Rehearing in Part, Clarifying Final Rule, and Denying Stay Request.

SUMMARY: The Federal Energy Regulatory Commission is granting in part and denying in part rehearing of, and clarifying, Order No. 451-A which amended Order No. 451. The final rule adopted in those orders established a new alternative ceiling price for old gas priced under sections 104 and 106 of the Natural Gas Policy Act of 1978. The final rule also established a "good faith" negotiation rule" with which producers must comply before collecting a higher price under an existing contract, absent voluntary renegotiation of the contract. In addition, the final rule provided blanket transportation certificates to non-Order No. 436 interstate pipelines which formerly purchased, or provided upstream transportation of, gas released under the good faith negotiation rule in order to facilitate marketing of that gas to a new purchaser. On rehearing of Order No. 451-A, the Commission amends the regulations implementing the good faith negotiation rule to clarify the effect of assignments on the parties' rights under that rule and to permit first sellers and purchasers to mutually agree to shorten the notice which must be given before sales or purchases are abandoned or terminated. The Commission also grants intra-

state pipelines a limited jurisdiction certificate to perform the same transportation which Order Nos. 451 and 451-A authorize or require non-Order No. 436 interstate pipelines to perform. Finally, the Commission denies the request of Williams Natural Gas Company for a stay of Order Nos. 451 and 451-A.

EFFECTIVE DATE: The amendments to the Commission's regulations adopted in this order shall become effective on June 3, 1987, except that §§ 284.225(f)(4) and (g) and 284.226(d) shall not become effective until July 9, 1987.

SUPPLEMENTARY INFORMATION:

Order Granting Rehearing in Part, Denying Rehearing in Part, Clarifying Final Rule, and Denying Stay Request

Before Commissioners: Martha O. Hesse, Chairman; Anthony G. Sousa, Charles G. Stalon, Charles A. Trabandt and C.M. Naeve.

I. Introduction

On December 15, 1986, the Commission issued Order No. 451-A[1] amending the final rule adopted in Order No. 451.[2] That final rule modified the price structure of old natural gas and established regulations governing implementation of the revised price structure. The Commission has received three timely applications for rehearing or clarification of Order No. 451-A, and five requests for reconsideration.[3] This order grants in part and denies in

[1] 51 FR 46762 (December 24, 1986).

[2] 51 FR 22168 (June 18, 1986).

[3] Meridian Oil, RM86-3-069, January 14, 1987; Independent Petroleum Association of America (IPAA), RM86-3-070, January 14, 1987; General Service Customer Group (GSC), RM86-3-071, January 14, 1987. On April 13, 1987 Williams Natural Gas Company

part rehearing of, and clarifies, Order No. 451-A. It also denies a request by Williams Natural Gas Co. that the Commission stay Order Nos. 451 and 451-A pending judicial review.

II. Background

In order No. 451, the Commission established a new, alternative ceiling price for old gas priced under sections 104 and 106 of the Natural Gas Policy Act of 1978 (NGPA).[4] That ceiling price is equal to the existing ceiling price for post-1974 old gas. In order to prevent indefinite price escalation clauses from automatically raising prices to the new ceiling price regardless of the market price, and in order to provide balanced negotiating rights among the parties, the Commission required that parties to existing contracts, who do not voluntarily negotiate a new or amended contract price, comply with a "good faith negotiation rule" before collecting higher prices. That rule establishes a three-step procedure by which contracts are placed on the bargaining table.

filed a motion for reconsideration of Order No. 451-A. Panhandle Eastern Pipe Line Co. (Panhandle) and Trunkline Gas Co. (Trunkline) filed a joint motion for reconsideration on April 23, 1987.

On February 5, 9, and 19, 1987, respectively, Texaco Inc., Arco Oil and Gas Co., and Conoco, Inc., filed "comments" on IPAA's request for rehearing generally supporting that request on the assignment issue. On March 16, 1987 Columbia Gas Transmission Corp. (Columbia) filed comments opposing IPAA's request for rehearing. On March 31, 1987 Amoco Production Company (Amoco) filed a response to Columbia's filing.

The Commission's procedural regulations do not permit answers to rehearing requests. 18 CFR 385.713(d)(1) (1986). However, the Commission will treat Texaco, Arco, and Conoco's comments as requests for reconsideration of Order No. 451-A since those comments seek changes in Order No. 451-A. Columbia's comments, which do not seek changes in Order No. 451-A, are rejected and will not be considered in this order. It follows that Amoco's response to Columbia's comments must also be rejected.

[4] 15 U.S.C. 3314 and 3316 (1982).

In step 1, a producer may request the purchaser to nominate a new price for any old gas sold under existing contracts which authorize a higher price. In step 2, the purchaser may request that the producer nominate a new price for any old or other gas sold by the producer under contracts covered by the producer's request. In addition, the purchaser may request the producer to nominate a new price for any gas sold by the producer under any other existing contract between the parties which contains some old gas. In step 3, the producer may request the purchaser to nominate a new price for its old gas in the contracts brought to the negotiating table by the purchaser in step 2. If the parties agree to a new price, sales continue under the existing contract at the agreed upon price. If the parties do not agree, the party that requested nomination of a price may cease sales or purchases of the gas covered by the nomination request and abandonment is deemed granted. Whenever gas previously sold to a non-Order No. 436 pipeline is eligible for release under the good faith negotiation rule, the producer must give the pipeline's firm sales customers a right of first refusal before selling released jurisdictional gas to a third party. Non-Order No. 436 interstate pipelines which formerly purchased released gas must transport that gas to their existing customers or to interconnecting pipelines. The Commission granted a blanket certificate for the performance of such transportation.

In Order No. 451-A, the Commission generally denied rehearing of Order No. 451. However, the Commission did modify the regulations governing the rates charged by non-Order No. 436 pipelines for transportation performed under the rule in order to assure that those rates are the same as those for comparable transportation under Order No. 436. The Commission also authorized non-Order 436 interstate pipelines, which provided transportation of released gas upstream of the releasing pipeline immediately before the release, to continue the transportation on behalf of any shipper. Finally, the Commission clarified the

operation of the good faith negotiation rule in various respects and made several minor modifications in the regulations implementing that rule. The applications for rehearing of Order No. 451-A raise a number of issues concerning the good faith negotiation rule and the transportation provisions of the final rule as modified in Order No. 451-A.

III. Discussion

1. The first, and perhaps most significant, issue raised concerns the operation of the good faith negotiation rule when a producer has assigned gas to another producer subject to an existing sales contract. On rehearing of Order No. 451, some rehearing applicants expressed concern that producers might seek to avoid renegotiation of their new gas in multi-vintage contracts in step 2 of the nominating process by transferring or assigning their old or their new gas to another entity so that all new and old gas is in separate contracts. The Commission stated that this was not a significant danger under the rule as adopted. As explained in the Order No. 451-A preamble:

> Mere assignment to another corporate entity of old or new gas covered by a multi-vintage contract without amendment of the sales contract itself could not insulate the new gas from renegotiation in step 2. This is because the original owner of the gas would still appear on the contract with the purchaser as the seller of that gas. The purchaser is entitled to obtain renegotiation in step 2 of all gas sold under the contract as it was on July 18, 1986, by the seller regardless of whether the seller claims someone else owns the gas.[5]

IPAA, Texaco, Conoco, and Arco assert that this statement is inconsistent with state law. Once an assignment has occurred, the assignor has no further legal authority to negotiate on behalf of the assignee. Thus, if a pro-

[5] 51 FR at 46,795-796.

ducer assigned its new gas to another producer and thereafter requested the purchaser to nominate a new price for its old gas, any request by the purchaser in step 2 that the assignor nominate a price for the new gas would be futile since that producer no longer has legal authority to negotiate the price of that gas.

IPAA suggests that, consistent with state law, the Commission modify the definition of "first seller" and "party to a contract," set forth in § 270.201(a)(2)(iii), to include only persons having a direct contractual relationship with the purchaser as of the date a nomination request is made. The effect of such a provision, in the absence of any other change in the regulations implementing the good faith negotiation rule, would be that when an assignor or assignee makes a nomination request in step 1, the purchaser in step 2 could only seek negotiation of gas currently sold it by that assignor or assignee. This is because the regulations currently permit the purchaser to seek renegotiation in step 2 only of gas sold it by the "first seller" who made the nomination request in step 1.

Texaco, Conoco, and Arco agree with IPAA that a purchaser should be permitted in step 2 to seek renegotiation only of gas currently sold it by the assignor or assignee initiating good faith negotiation at least where the assignor and assignee are not affiliated. They state that there is little danger that producers will significantly circumvent purchasers' step 2 rights through assignment except possibly where producers are affiliated. Too many other considerations are involved when producers assign gas leases for them to manipulate such assignments for purposes of circumvention. Texaco also states that producers lack any incentive to try to circumvent the purchasers' step 2 rights, since, as the Commission stated in Order No. 451, the price of high-cost new gas will be forced downward as a result of higher prices for old gas even apart from the purchaser's rights in step 2.

Furthermore, Texaco, Conoco, and Arco contend that permitting the purchaser to renegotiate both the assignor's and assignee's multi-vintage gas when only one of them initiates good faith negotiation could be unfair to some producers. For example, an assignor who assigned old gas in one contract for legitimate business reasons could find all its multi-vintage contracts subject to good faith negotiation solely because of the actions of the assignee, even though the assignor desired to forego good faith negotiation.[6] Texaco states that, in order to avoid this possibility, it has begun requiring persons to whom it makes assignments to waive any rights to initiate good faith negotiation with respect to the assigned gas as a condition of the assignment. While Texaco, Conoco, and Arco agree with IPAA that a purchaser in step 2 should be limited to seeking renegotiation only of gas currently sold it by the assignor or assignee initiating good faith negotiation, they contend that that result can be achieved under the existing regulations and that there is no need for the amendment suggested by IPAA. They also state that, if the Commission desires to prevent circumvention by affiliates, it should adopt a regulation addressing that specific problem.

The Commission agrees with Texaco that, over the long term, any attempt through an assignment to insulate high-cost gas from renegotitaion downward is likely to prove futile. As discussed in detail in Order No. 451,[7] the Commission expects new gas prices to be renegotiated downward as a result of the market forces released under this rule, apart from the rights granted purchasers in step 2. However, the Commission nevertheless found the purchaser's step 2 rights necessary to assure that in the short term there is no lag between

[6] Similarly, the gas assigned to the assignee could likewise become subject to renegotiation solely because the assignor initiated good faith negotiation.

[7] 51 FR at 22196-198.

the producer's obtaining a higher price for old gas and the purchaser's obtaining lower prices for new gas sold in multi-vintage contracts.[8] The Commission desires to minimize any possible circumvention of this assurance by producers through assignments. The danger of circumvention is not limited to assignments among affiliates, as suggested by Texaco, Conoco, and Arco. For example, a producer who owned mostly new gas and therefore did not desire to initiate good faith negotiation might sell its old gas in a multi-vintage contract to a second, unaffiliated producer for a price based upon the value of the gas when sold subject to the alternative ceiling price. When the second producer initiated good faith negotiation for the assigned gas, the purchaser would not be able to make a nomination request in step 2 for the unassigned new gas. Accordingly, the Commission does not adopt the rehearing applicants' proposal.

However, the Commission is sympathetic with the concern of Texaco, Conoco, and Arco that permitting the purchaser in step 2 to make nomination requests with respect to all gas which would have been eligible for renegotiation in the absence of the assignment—the approach suggested in the Order No. 451-A preamble—could be unfair to some producers. As stated by the rehearing applicants, only the assignee has power to contract with respect to the assigned gas, just as only the assignor has power to contract with respect to the unassigned gas.[9] Therefore, in order to implement the approach suggested in the Order No. 451-A preamble, the purchaser would have to be given the right, when an assignor or its assignee initiates good faith negotiation, to request the other to nominate a price for any gas

[8] Order No. 451-A, 51 FR at 46,788-789.

[9] In general when a producer assigns gas to another producer, the assignee succeeds to all the rights and obligations of the assignor with respect to the assigned gas. *See* 4 Williams, Oil & Gas Law § 735 (1985).

which would have been subject to good faith negotiation in the absence of the assignment. This would mean that an assignor or assignee who did not desire to engage in good faith negotiation could nevertheless be drawn into such negotiation as a result of the nomination request of the other. This could have a particularly adverse effect on assignors, all of whose multi-vintage contracts would become subject to good faith negotiation as a result of a nomination request by the assignee.

For these reasons, the Commission is modifying Order No. 451-A with respect to assignments (or other transfers that in substance yield the same effect) on or after the issuance of this order as follows. A producer who validly assigns gas subject to a contract existing on July 18, 1986 which included old gas will be ineligible to initiate good faith negotiation for any gas it sold to the purchaser unless the purchaser in step 2 can renegotiate all the gas which would have been subject to renegotiation in the absence of the assignment. The same rule will also apply to the assignee; however, its ineligibility to initiate good faith negotiation will be limited to the assigned gas.[10] The purchaser's ability to renegotiate the gas which would have been subject to renegotiation in the absence of the assignment could arise, for example, through an agreement by the assignor or assignee to permit renegotiation of its gas if the other initiates good faith negotiation or through the assignment itself under state law. This rule will protect purchasers from circumvention of their step 2 rights as a result of assign-

[10] The assignee's ineligibility need not extend to the gas it sells under its own contracts with the purchaser in order to prevent circumvention of the purchaser's step 2 rights. If there had been no assignment and the assignor had requested the purchaser to nominate a price for the assigned gas, the purchaser would not have been entitled in step 2 to reach the assignee's gas. The purchaser could only reach that gas if the assignee makes a nomination request for some of its gas, and in such circumstances the purchaser can reach that gas in step 2 after the assignment as well as before.

ments after the issuance of this order, without requiring any producers involuntarily to renegotiate their gas except where state law permits purchasers to require such renegotiation.

The Commission will not apply the above described rule to assignments before the issuance of this order. In its interim order on rehearing issued July 18, 1986, the Commission stated that it would only change its regulations governing eligibility to initiate good faith negotiation prospectively. Those regulations, as in effect before issuance of this order, permitted producers to make assignments without potential loss of eligibility to initiate good faith negotiation.[11] It would be unfair to deprive a producer of its eligibility for good faith negotiation because of an assignment made when the Commission had given no notice that assignments could cause such a loss of eligibility. However, as stated above, the Commission believes that the rule suggested by the Order No. 451-A preamble is also unfair. Accordingly, the Commission has determined not to apply that rule to assignments before the issuance of this order either. Rather, this order provides that, when gas in an existing contract including old gas has been assigned before the issuance of this order, the purchaser in step 2 may seek renegotiation of any multi-vintage or old gas currently sold by the assignor or assignee initiating good faith negotiation, but not any other gas. Accordingly, assigned gas shall be subject to renegotiation in step 2 only when the assignee initiates good faith negotiation for old gas in any of its contracts with the purchaser. Similarly, the unassigned gas will be subject to renego-

[11] *See* Order No. 451-A, 51 FR at 46796, in which the Commission raised the possibility of loss of eligibility for good faith negotiation as a result of an assignment only if the producer and the purchaser actually amended the sales contract to name the assignee as a seller.

tiation in step 2 only when the assignor initiates good faith negotiation.[12]

Furthermore, the Commission believes that any impact on purchasers as a result of some above-market gas not being subject to renegotiation in step 2 through application of the above described rule will often be counterbalanced by other high-cost gas becoming subject to renegotiation which otherwise would not have been. For example, a producer who does not intend to initiate good faith negotiation may, for legitimate business reasons, have assigned high-cost gas to another producer who owns a large amount of old gas and will initiate good faith negotiation. As a result the purchaser will now have an opportunity to renegotiate that gas in step 2 which it would not have had without the assignment.[13] Finally, even when high-cost gas is not subject to renegotiation in step 2 as a result of an assignment before issuance of this order, the competitive forces in the natural gas market released by this rule should enable the purchaser to renegotiate that gas downward. The Commission concludes that the rule adopted here governing assignments before the date of this order provides the best method of handling such assignment, since these rules should not result in significant circumvention of the purchaser's step 2 rights and the identified alternatives as discussed could have an unfair impact.

[12] This result is reached through application of the existing regulations governing the purchaser's step 2 rights. Under § 270.201(b)(2) the purchaser may make a nomination request in step 2 only to the "first seller" initiating good faith negotiation. That "first seller" under § 270.201(b)(2) is the assignor or assignee initiating good faith negotiation.

[13] It should be observed that no assignment after July 18, 1986 of the old or new gas in a multi-vintage contract can alter the fact that the new gas is sold under a multi-vintage contract including the sale of old gas. Pursuant to § 270.201(a)(2)(ii)(B), a contract includes the sale of old gas if on July 18, 1986 it encompassed the sale of such gas.

The Commission is also amending the regulations governing good faith negotiation so as to authorize the purchaser, when gas is assigned after the issuance of this order and the assignor or assignee is eligible to initiate good faith negotiation,[14] to renegotiate in step 2 all gas which would have been subject to renegotiation in the absence of the assignment. This amendment is necessary, since the current regulations do not specifically authorize the purchaser, in any circumstances when an assignee or assignor initiates food faith negotiation, to request the other to nominate a price for its gas. When a producer who assigned gas after the issuance of this order initiates good faith negotiation for gas sold under the contract which includes the assigned gas or sold under another contract, the amended regulations authorize the purchaser in step 2 to request the assignee to nominate a new price for the assigned gas. The purchaser may also request the assignor to nominate a new price for any unassigned gas in the assignor's multi-vintage contracts with the purchaser which contain some old gas. If the assignee initiates good faith negotiation, the purchaser may request in step 2 that the assignor nominate a new price for any unassigned gas in any of its multi-vintage contracts with the purchaser. The purchaser also may request that the assignee nominate a new price for the assigned gas. However, the purchaser may not request the assignee to nominate a new price for any other gas sold under contracts between the purchaser and the assignee. The purchaser could not have reached that gas if the assignment had never occurred and the assignor had initiated good faith negotiation.[15] These procedures

[14] As discussed above, the assignor or assignee would be eligible to initiate good faith negotiation if the other agrees that the purchaser may renegotiate its gas in step 2, state law permits the purchaser to do so, or for some other reason the purchaser must be given such a right.

[15] For the same reasons, if the assignee requests the purchaser to nominate a price for gas sold under its own contracts with the

are designed only to give the purchaser the same rights it would have had in the absence of an assignment, not to expand those rights.

While in the circumstances described above, when an assignor or assignee initiates good faith negotiation, the purchaser may make nomination requests to the other, the assignor and assignee are still considered separate first sellers and parties to the contract for purposes of the good faith negotiation rule. Thus, when the purchaser makes nomination requests to both, each must nominate a price for its gas and the purchaser may accept the nomination of one and reject the nomination of the other as it chooses although, consistent with the rules governing good faith negotiation generally, the purchaser cannot partially accept or reject the nomination of a particular assignor or assignee. Furthermore, if an assignor or assignee initiates good faith negotiation and the purchaser does not exercise its right to request the other to nominate a price, then the negotiation between the party initiating good faith negotiation and the purchaser will not affect the other's right subsequently to initiate good faith negotiation. An assignor or assignee loses its right subsequently to initiate good faith negotiation only if its gas is placed on the bargaining table.[16] Of course, if the purchaser does request the other to nominate a price, the assignor or assignee must make any nomination request it desires in step 3. This is consistent with the general rule governing signatory working interest owners' loss of the right to initiate good faith negotiation. *See* Order No. 451-A, 51 FR at 46801.

2. Williams Natural Gas Company (Williams) requests that the Commission expand purchasers' step 2 rights to permit purchasers to seek lower prices for new

purchaser, the purchaser may not request the assignee in step 2 to nominate a price for the assigned gas.

[16] See 18 CFR 270.201(a)(4).

gas covered by any contract between the parties, regardless of whether that contract includes old gas. Williams states that this change in Order Nos. 451 and 451-A is necessary because of the decision of the Tenth Circuit Court of Appeals in *Martin Exploration Management Co. v. FERC*[17] In that case, the court reversed the Commission's holding in Order No. 406[18] that, when gas has been determined to qualify for both a deregulated gas category and a regulated category, the gas is deemed deregulated. Among the categories of gas which were deemed price-deregulated under Order No. 406 was certain gas qualifying under NGPA section 107(c)(5) as new tight formation gas. Order No. 406 thus permitted many purchasers to pay less than the relatively high section 107(c)(5) ceiling price for that gas through, for example, contract clauses providing for price redetermination upon deregulation. Williams alleges that the reversal of Order No. 406 means that producers with indefinite price escalation clauses will now again be eligible to receive the section 107(c)(5) ceiling price, currently $6.36. This could significantly increase pipelines' cost of gas. Williams states that expansion of purchasers' step 2 renegotiation rights will give pipelines an opportunity to mitigate the effect of *Martin*.

The Commission does not adopt Williams' proposal. The reasons the Commission gave in Order No. 451-A for refusing to permit purchasers in step 2 to renegotiate new gas not in multi-vintage contracts are as valid after *Martin* as before. As the Commission stated in Order No. 451-A, the competitive forces in the natural gas market, which will be strengthened by the increased production and more accurate price signals resulting from this rule, will over time force down new gas prices wholly

[17] Case No. 84-2756, *et al.*, decided March 9, 1987.

[18] Deregulation and Other Pricing Changes on January 1, 1985, Under the Natural Gas Policy Act, 49 FR 46874 (Nov. 29, 1984).

apart from the good faith negotiation rule.[19] Thus, it is unnecessary to expand the purchasers' step 2 rights in order to enable them to bring down the price of new gas, including section 107(c)(5) gas. Furthermore, permitting the purchaser to renegotiate all new gas would increase the potential cost to many producers of initiating good faith negotiation, with the result that fewer producers would do so. This would seriously impede achievement of the Commission's goal of market responsive prices for old gas so as to avoid premature abandonment of that gas. Therefore, the Commission continues to believe that a proper balance between the need for higher prices for old gas and fairness to purchasers is achieved by permitting purchasers to renegotiate in step 2 only new gas sold in multi-vintage contracts. This assures that there is no lag between the producer's obtaining a higher price for old gas and the purchaser's obtaining a lower price for new gas sold under multi-vintage contracts, thereby avoiding disruption of the mutuality of consideration in multi-vintage contracts in which all terms are interrelated. At the same time, however, it avoids making good faith negotiation so costly that few producers initiate it.

3. Meridian observes that some multi-vintage contracts may provide no authority for a higher price for the old gas and yet also contain high-priced new gas. An example would be a contract containing only minimum rate old gas and deregulated new gas. Meridian requests clarification whether the producer may request a price nomination for the old gas in such a contract in step 3, if the purchaser requests a price nomination for the new gas in step 2. The situation posed by Meridian cannot arise because the purchaser could not make a nomination request with respect to the contract in question in step 2. Section 270.201(b)(2) only authorizes the purchaser to make nomination requests in step 2

[19] 51 FR at 46790-791.

with respect to "any existing contract with the purchaser that includes the sale of any old gas." Section 270.201(a)(2)(ii)(A) defines "existing contract" as a contract in effect on July 18, 1986 "that . . . provides authority for the first seller to collect a higher price upon establishment by the Commission of a higher maximum lawful price." Thus, the only multi-vintage contracts which the purchaser in step 2 can bring to the bargaining table are those which permit a higher price for at least some of the old gas in the contract. Of course, where the purchaser in step 2 requests the producer to nominate a price for new gas in a multi-vintage contract providing authority for a higher price for some but not all of the old gas in the contract, the producer in step 3 could only request the purchaser to nominate a price for the old gas for which there was authority for a higher price.

4. A producer must enter into a contract to sell to a third party and give the purchaser 30 days' notice before terminating sales under the good faith negotiation rule. IPAA requests that the Commission clarify that, where a producer must comply with the Order No. 451 right of first refusal, it may give the 30 days' notice to the pipeline as soon as it has obtained an offer substantially accepted in principle from the non-firm sales customer, rather than waiting until it has executed a contract with either the non-firm sales customer or a firm sales customer exercising its right of first refusal. Permitting the 30-day notice period to run concurrently with the presentation of a third-party offer to the pipeline's firm sales customer allegedly would further the policy objectives of Order No. 451 by permitting released or abandoned gas to be sold to alternative purchasers at market-responsive prices more quickly. It would also make third parties more willing to purchase released gas since deliveries could start more quickly after the agreement in principle with the producer. Finally, because some pipelines require transportation to begin within a certain

period of the signing of the transportation agreement, arrangement of transportation to the new purchaser would be easier.

The Commission rejects IPAA's proposed clarification. In Order No. 451-A, the Commission clearly stated its intent that the producer must execute a contract with the new purchaser before giving the existing purchaser the 30 days' notice of termination of sales.[20] When the producer must give the firm sales customers a right of first refusal of an offer accepted by a non-firm sales customer, no contract can be executed until after the offer has been presented to the firm sales customers. Accordingly, the 30 days' notice cannot be given until after the right of first refusal has been complied with. Without the requirement of an executed contract before the producer gives the 30 days' notice, there would be a possibility that upon completion of the 30-day notice period the producer still would not have executed a contract to sell the gas to another purchaser and thus would not qualify for the abandonment granted under the good faith negotiation rule.[21] It would be difficult for the purchaser to contract to purchase replacement supplies from another producer if it could not be certain that upon completion of the 30-day notice period sales by the first producer

[20] 51 FR at 46784.

[21] Even if the producer had presented a third-party offer to firm sales customers concurrently with giving the 30 days' notice so that the 20-day period for responding to the third party offer would expire before the 30 days' notice, there could be no certainty that a sales contract would actually be executed with a new purchaser before the end of the 30-day notice period. If all the firm sales customers rejected the third-party offer, the deal between the producer and the non-firm sales customer might still fall through, requiring the producer to start all over again looking for a new purchaser and comply with the right of first refusal a second time if the next potential purchaser is a non-firm sales customer. If more than one firm sales customer accepted the offer, it might take beyond the 30 days' notice period for the producer to choose to which one to sell and execute a contract.

would be abandoned. Avoiding any uncertainty over whether the abandonment will occur at the end of the 30-day notice period justifies any additional delay in the commencement of sales to the new purchaser. Such additional delay would in no event be more than the 30-day notice period. With regard to IPAA's concern about pipeline requirements that transportation service begin within a certain period after it is arranged, the Commission observes that operational conditions imposed on any transportation service required by Order No. 451 must be reasonable and not unduly discriminatory or preferential. Such operational conditions may not be imposed in order to avoid the Order No. 451 transportation obligation.

5. Purchasers must give the first seller 60 days' notice before abandoning or terminating purchases under the good faith negotiation rule. Panhandle and Trunkline request that the Commission provide that the first seller and purchaser may mutually agree to shorten this 60-day notice period. The Commission established the 60-day notice period in order to give the first seller a reasonable opportunity to arrange sales to an alternative purchaser.[22] Since the 60-day notice period is for the protection of the first seller ,there appears no reason not to permit the first seller to waive that notice through a mutual agreement with the purchaser. In addition, such a shortening of the notice period would permit the Commission's goal of more market-responsive pricing to be achieved more quickly for the gas in question. The Commission believes that the same reasoning also supports permitting the first seller to abandon or terminate sales under the good faith negotiation rule upon less than the required 30 days' notice when the parties mutually so agree. Accordingly, the Commission is modifying its regulations to permit the parties to mutually agree to shorten the notice period for termination or abandonment of both sales and purchases.

[22] Order No. 451-A, 51 FR at 46799.

6. In Order No. 451-A, the Commission stated that a firm sales customer's Order No. 451 right of first refusal and a non-Order No. 436 pipeline's NGPA section 315(b) right to a bona fide offer and right of first refusal [23] could never arise simultantously with respect to the same gas. The Order No. 451 right of first refusal only applies to non-jurisdictional gas such as that covered by section 315(b) if it is packaged with jurisdictional gas. The Commission stated that a producer may not package gas covered by section 315(b) with other gas when giving the original purchaser its section 315(b) rights. Accordingly, the gas covered by section 315(b) will never be available for packaging with released jurisdictional gas for purposes of the Order No. 451 right of first refusal. IPAA questions whether the Commission's section 315(b) regulations prohibit the packaging of 315(b) gas with other gas. Accordingly, it suggests that under the Commission's current regulations producers may be required with respect to the same gas both to give the original purchaser its section 315(b) rights and to give the firm sales customers a right of first refusal under Order No. 451. It proposes that the Commission solve this problem by amending its section 315(b) regulations to provide that a producer's compliance with the Order No. 451 right of first refusal extinguishes the original purchaser's section 315(b) rights.

The Commission rejects IPAA's proposal. First, that proposal would violate section 315(b) by depriving the original purchaser of its right under that section to receive a bona fide offer and right of first refusal. Second, IPAA is incorrect in suggesting that a producer may package gas covered by section 315(b) with other gas

[23] Section 315(b) requires that when a contract for the sale of NGPA section 102(c), 103(c), or 107(c)(1)-(4) gas which was subject to the Commission's Natural Gas Act (NGA) jurisdiction on the day before enactment of the NGPA expires or is terminated, the seller must give the existing purchaser a bona fide offer and right of first refusal before selling that gas to a third party.

when giving the original purchaser its section 315(b) rights. Section 315(b) requires that the producer give the original purchaser a bona fide offer and right of first refusal with respect to the gas covered by that section. Inclusion of other gas in the offer presented to the original purchaser would mean that the offer was not an offer to continue sales of the gas covered by section 315(b), but an offer only to sell a larger package of gas. Furthermore, permitting the producer to include other gas in the offer would allow it to circumvent the original purchaser's section 315(b) rights by including a large amount of other gas for which the purchaser had no need. As explained in Order No. 451-A,[24] since the non-jurisdictional gas covered by section 315 cannot be packaged with the jurisdictional gas covered by the Order No. 451 right of first refusal for purposes of giving the original purchaser its section 315(b) rights, there can be no overlay between the section 315(b) and the Order No. 451 rights of first refusal.

7. NGPA section 315(a) requires the Commission to prescribe a rule providing that contracts for the first sale of Outer Continental Shelf gas qualifying under NGPA sections 102(b) or 107(c)(1)-(4) be for a duration of not less than 15 years. IPAA requests that the Commission modify 18 CFR 277.101, adopted pursuant to section 315(a), so as to exclude from the 15-year duration requirement contracts for the sale of the relevant Outer Continental Shelf gas where that gas has been released under the good faith negotiation rule. Adoption of the proposed modification would violate section 315(a)'s requirement that contracts for the sale of all section 102(b) or 107(c)(1)-(4) Outer Continental Shelf gas be for a term of at least 15 years. Accordingly, the Commission cannot modify its regulations as proposed.

8. IPAA requests that the Commission modify the non-discriminatory access provision imposed on intra-

[24] 51 FR at 46805.

state pipelines performing transportation under NGPA section 311(a)(2) by Order No. 436[25] so as to permit intrastate pipelines to transport gas released under the good faith negotiation rule without being subject to the nondiscriminatory access provision. IPAA argues that such a modification is necessary to permit intrastate pipelines unwilling to become open access pipelines to transport gas released under the good faith negotiation rule and would be analogous to the transportation authorizations provided non-Order No. 436 interstate pipelines in Order Nos. 451 and 451-A.

The Commission agrees that, to the extent intrastate pipelines require Commission authorization to transport gas, those pipelines should be authorized to perform transportation analogous to that which Order Nos. 451 and 451-A authorize or require non-Order No. 436 interstate pipelines to perform. The same policy considerations supporting the transportation authorization for non-Order No. 436 interstate pipelines also apply in the case of intrastate pipelines. In order for the potential benefits of this rule to be realized in terms of both supply and price response, producers must be able to market released gas. Some producer's ability to market released gas could be hindered when an intrastate pipeline unwilling to become subject to the non-discriminatory access provisions of Order No. 436 refuses to perform section 311(a)(2) transportation. Accordingly, the Commission shall provide blanket "limited jurisdiction" section 7(c) certificates authorizing intrastate pipelines which either purchased, or provided upstream transportation of, released gas immediately before its release to transport that gas on behalf of either interstate pipelines or local distribution companies served by interstate pipelines. All transportation under these certificates shall be voluntary.

[25] 18 CFR 284.9(b). Under section 311(a)(2), the Commission may authorize intrastate pipelines to transport gas on behalf of interstate pipelines or local distribution companies served by interstate pipelines.

As we stated in Order 451-A with respect to upstream interstate pipelines, any intrastate pipeline electing to provide transportation under this authorization must do so in a not unduly discriminatory manner. *See* 51 FR at 46809.

The rate charged by an intrastate pipeline for transportation of released gas which the pipeline purchased immediately before the gas's release shall be determined pursuant to § 284.123(b). This assures that the rate shall be the same as if the transportation were provided under section 311(a)(2). The rate charged by an intrastate pipeline for upstream transportation of released gas shall be identical to the rate charged for the same service previously provided to the releasing pipeline.

9. The Order No. 451 transportation obligation and the Order No. 451 right of first refusal apply only to non-Order No. 436 interstate pipelines and the firm sales customers of such pipelines respectively. Order No. 451 defines non-Order No. 436 pielines as pipelines not subject to the non-discriminatory access provisions of § 284.8(b) and § 284.9(b). Pipelines performing section 311 transportation on an interim basis [26] are subject to these non-discriminatory provisions [27] and accordingly are considered Order No. 436 pipelines for purposes of Order No. 451. GSC and IPAA assert that this means such pipelines could nullify their customers' ability to obtain alternative supplies through the Order No. 451 right of first refusal and transportation provisions by going through good faith negotiation while still an Order No.

[26] The Commission has authorized certain pipelines to continue transportation under section 311 without becoming subject to the contract-demand reduction and conversion rights in section 284.10 until 30 days after the Commission issues the first order on rehearing of the individual pipeline's pending Order No. 436 settlement or blanket certificate. *See Texas Eastern Transmission Corp.*, 39 FERC ¶ 61,027 (1987).

[27] *Texas Eastern Gas Pipeline Co.*, 33 FERC ¶ 61,159 (1985).

436 pipeline performing interim section 311 transportation but thereafter ceasing the interim transportation. The pipeline could then refuse to transport any gas to the customers not purchased from the pipeline. GSC suggests that the Commission solve this problem by expanding the definition of non-Order No. 436 pipelines to include all pipelines who have not been granted and accepted an Order No. 436 blanket certificate under § 284.221 of the Commission's regulations. IPAA suggests alternatively that the Commission require that an Order No. 436 pipeline certify that it will remain such for at least 12 months. In the absence of such certification the Order No. 451 transportation obligation would apply to such pipelines.

The Commission refuses to modify Order No. 451's definition of non-Order No. 436 pipelines or to adopt IPAA's alternative suggestion. So long as a pipeline is subject to the non-discriminatory access provisions of Order No. 436, there is no reason to require it to transport gas under Order No. 451 or to give the pipeline's firm sales customers a right of first refusal. Transportation is already available under the non-discriminatory access provisions, thus permitting customers to purchase alternative supplies from any source and have that gas transported to them. It is true that pipelines may terminate the performance of interim section 311 transportation at any time and must do so when certain Order No. 436 filings have been processed. Nevertheless, the Commission does not believe that this fact will enable pipelines to prevent their customers from purchasing gas from alternative suppliers in the manner suggested by GSC and IPAA. Any pipeline terminating interim transportation that does not accept an Order No. 436 certificate or continue section 311 transportation [28] would be re-

[28] Of course, if the pipeline does accept an Order No. 436 certificate or continues section 311 transportation, transportation would be available to its customers under Order No. 436 on a long-term basis after interim transportation ends.

quired under Order No. 451 to transport gas released under the good faith negotiation rule to its customers or interconnecting pipelines. This requirement would apply to all released gas regardless of whether the release occurred before or after the interim transportation ceased. In addition, the firm sales customers of such a pipeline would be entitled to a right of first refusal as to all released gas not already sold to a third party. With all interim transportation authority scheduled to end upon the processing of certain Order No. 436 filings, it is likely that a substantial portion of the gas ultimately released under the good faith negotiation rule will not be released until after the termination of interim transportation and would thus remain available for the firm sales customers' right of first refusal. This is particulary true in light of the fact that pipelines have no control over the timing of good faith negotiation. Initiation of good faith negotiation is in the sole discretion of the producer. It appears that many producers are delaying initiation of good faith negotiation while they seek voluntary negotiation or for other reasons. Finally, the Commission observes that although pipelines may terminate interim transportation, the Commission has stated that such termination must not be unduly discriminatory.[29]

10. In Order No. 451-A, the Commission held that a non-Order No. 436 pipeline's election to bid less than the highest price permitted under its contract necessarily includes an agreement to waive any full requirements or sole supplier clause which would prevent a firm sales customer from exercising its right of first refusal.[30] Otherwise, the right of first refusal granted such customers would be a nullity. GSC contends that the Commission should extend this waiver requirement to Order No. 436 pipelines. It observes that, in refusing to extend the right of first refusal to the customers of an Order No. 436

[29] *Columbia Gas Transmission Corp.*, 33 FERC ¶ 61,158 (1985).

[30] 51 FR at 46811.

pipeline, the Commission stated that such customers have no need of the right of first refusal, since they can purchase any gas, whether or not previously sold to the pipeline or released under the good faith negotiation rule, and obtain transportation from the Order No. 436 pipeline. However, GSC states that a full requirements clause may bind customers of Order No. 436 pipelines to purchase from the Order No. 436 pipeline, particularly where the pipeline is only performing interim transportation and is thus not subject to the contract demand reduction and conversion rights of § 284.10. GSC states that the Commission has not yet clarified this issue. Accordingly, GSC contends that a requirement that an Order No. 436 pipeline potentially losing gas under the good faith negotiation rule waive any full requirements clause is necessary to ensure that its customers may purchase gas from alternative suppliers.

The Commission will not extend the waiver requirement to Order No. 436 pipelines. Where a pipeline has accepted an Order No. 436 blanket certificate or commences or continues a section 311 transaction after expiration of its interim transportation authorization and is therefore subject to the contract-demand reduction and conversion requirements of § 284.10, it must agree to modify any existing contract terms, such as a full requirements clause, which would prevent the customer's exercise of these options.[31] In such circumstances, therefore, a customer currently subject to a full requirements clause could nevertheless, through the exercise of its contract demand reduction and conversion rights, purchase gas from alternative suppliers and obtain transportation of that gas by the pipeline.[32]

[31] *See* Order No. 436, *FERC Statutes and Regulations, Regulations Preambles 1982-1985* ¶ 30,665, at 31,530, and *Northwest Central Pipeline Co.*, 38 FERC ¶ 61,170, at 61,542-543 (1987).

[32] Of course, since the customer would no longer be a full requirements customer, it might no longer be entitled to purchase gas from the pipeline at the full requirements rate.

Customers of Order No. 436 pipelines performing only interim transportation under section 311 would, it is true, have no contract demand reduction and conversion rights under § 284.10 and thus would be unable to purchase from another supplier unless the pipeline voluntarily agreed to modification of the full requirements clause. However, this situation will be only temporary. Interim transportation is scheduled to cease upon the processing of certain Order No. 436 filings. When that happens, pipelines bust either (1) continue Order No. 436 transportation under a blanket certificate or section 311 which would require them to offer their customers the contract-demand reduction and conversion option in § 284.10 or (2) stop all Order No. 436 transportation, which would require them to waive any full requirements clauses preventing any firm sales customer from exercising the Order No. 451 right of first refusal. In either case, the customers could purchase gas from alternative suppliers. They could also obtain transportation, either under the Order No. 436 non-discriminatory access provisions or under the Order No. 451 transportation obligation. As discussed in the preceding section, the Commission expects that a substantial portion of the gas ultimately released under the good faith negotiation rule will not be released until after interim section 311 transportation ceases and will thus remain available for the Order No. 451 right of first refusal at that time. Accordingly, the Commission believes that the full requirements customers of pipelines currently performing interim section 311 transportation will have ample opportunity to purchase gas from alternative suppliers. Therefore, there is no need to further complicate the rule by requiring pipelines performing interim transportation to waive full requirements clauses.

11. IPAA states that some Order No. 436 pipelines might not provide transportation for amounts of gas below a particular minimum. A package of gas released under the good faith negotiation rule for which transportation is desired might be less than the applicable minimum. In such instances IPAA suggests that the Order No. 451 transportation provisions should apply even though the pipeline is an Order No. 436 pipeline. The Commission refuses to adopt this suggestion. Minimum volume conditions violate the non-discriminatory access provisions of Order No. 436 unless they can be justified as reasonable operating conditions.[33] In *Texas Eastern Transmission Corp.*, the Commission eliminated a minimum volume condition from Texas Eastern's Order No. 436 settlement on the ground that it was not necessary for operational reasons such as ensuring that the quantities of gas to be transported would be large enough to be metered.[34] Where an Order No. 436 pipeline's minimum volume condition is valid as a reasonable operating condition, that condition would likely also be a valid condition to any transportation under Order No. 451, since transportation under that order is also subject to reasonable operating conditions. *See* 18 CFR 284.225(f). Accordingly, if transportation pursuant to Order No. 436 is unavailable because of a minimum volume condition, transportation under Order No. 451 would also be unavailable. Therefore, no purpose would be served by applying the Order No. 451 transportation provisions to Order No. 436 pipelines in the situation described by IPAA.

12. Section 270.226(a) defines upstream pipelines for purposes of the upstream transportation authorization as interstate pipelines "authorized under a certificate of public convenience and necessity" to transport the gas, before its release, between the wellhead and the releasing pipeline. IPAA states that the requirement that the prior transportation have been pursuant to a certificate of public convenience and necessity appears to exclude from

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[33] Order No. 436, ***FERC Statutes and Regulations, Regulations Preambles 1982-1985*** ¶ 30,665, at 31,495.

[34] 37 FERC ¶ 61,260, at 61,680 (1985).

the upstream transportation authorization interstate pipelines previously performing transportation other than under a section 7(c) certificate. An example would be grandfathered section 311 transportation under § 284.105. IPAA requests that the Commission expand the upstream transportation authorization to cover such pipelines. In Order No. 451-A, the Commission stated that the upstream transportation authorization was intended to "serve the twin public interest goals of protecting existing firm customers *and* continuing the flow of gas to the market."[35] Continued upstream transportation by interstate pipelines serves these goals regardless of the authority under which it was previously performed. Accordingly, the Commission is amending § 270.226(a) to remove the requirement that the prior transportation have been pursuant to a certificate of public convenience and necessity.

13. Williams Natural Gas Co. (formerly Northwest Central Pipeline Corporation) has requested that the Commission stay Order Nos. 451 and 451-A pending judicial review. Williams asserts that the final rule adopted in those orders is illegal and will cause Williams irreparable harm. Thirteen producers have submitted a joint answer to Williams' request, opposing it.

The Commission rejected similar stay requests in Order No. 451-A, holding pursuant to the standard set forth in the Administrative Procedure Act, 5 U.S.C. 705 (1982), that justice did not require a stay.[36] For essentially the same reasons, the Commission rejects Williams' stay request. The Commission answered all arguments concerning the illegality of Order No. 451, including those now made by Williams, in detail in Order No. 451-A. Furthermore, Williams's contention that Order Nos. 451 and 451-A will cause it irreparable harm is

[35] 51 FR at 46809 (emphasis in original).

[36] 51 FR at 46817.

speculative and unsubstantiated. There is no certainty that all, or even many, producers who sell gas to Williams will initiate good faith negotiation. Even if all do, Williams could, as stated in Order No. 451-A, offset over two-thirds of any old gas price increase to an estimated market price of $1.80/MMBtu by reducing its new gas WACOG to $1.68/MMBtu, its current all-gas WACOG. Furthermore, the Commission considers it unlikely old gas suppliers could sustain price increases in excess of Williams' $1.68/MMBtu old gas WACOG.[37] In any event, even if Williams does suffer economic damages, such damages are insufficient to constitute "irreparable harm." *See, e.g., Wisconsin Gas Co. v. FERC*, 758 F.2d 669, 674 (D.C. Cir. 1985), citing *Virginia Petroleum Jobbers Association*, 259 F.2d 921, 925 (D.C. Cir. 1958). If the courts modify Order No. 451 on review, monetary adjustments may be made to make the parties whole. Finally, the long-term public interest benefits to consumers and the industry as a whole of the greater degree of market-responsiveness in the gas markets resulting from the rule outweigh any initial detriment to those few entities that benefited from a distorted market.

IV. Effective Date and Paperwork Reduction Act Statement

The amendments to the Commission's regulations adopted in this order on rehearing shall become effective upon issuance of this order except that §§ 284.225(f)(4) and (g) and 284.226(d), involving reporting requirements, shall not become effective until July 9, 1987. In addition, the amendments to 18 C.F.R. 270.201 shall not

[37] Williams' allegations of harm as a result of *Martin's* reversal of Order No. 46 are irrelevant to a consideration of whether Order Nos. 451 and 451-A should be stayed. Any harm, as alleged by Williams, of increased gas sales prices that may result from *Martin* would occur regardless of whether Order Nos. 451 and 451-A were stayed.

apply to negotiations under the good faith negotiation rule comenced by a nomination request under § 270.201 (b)(1) made by the first seller before the issuance of this order.

The Administrative Procedure Act generally requires that a substantive rule be published "not less than 30 days before its effective date." 5 U.S.C. 553(d). However, there are exceptions to the advance notice requirement where a substantive rule "relieves a restriction" or where the Commission otherwise finds good cause to make the rule effective less than 30 days after publication. 5 U.S.C. 553(d)(1) and (3). There is good cause to make the amendments adopted here effective immediately. While the preamble to Order No. 451-A suggested that purchasers could renegotiate in step 2 all gas in multi-vintage contracts as those contracts existed on July 18, 1986, regardless of subsequent assignments, the regulations adopted in that order only permitted purchasers to renegotiate gas currently owned by the assignor or assignee initiating good faith negotiation. *See* the discussion at page 11. Therefore, making the amendments concerning asignments effective immediately is necessary to prevent producers from circumventing the purchaser's step 2 rights through assignments after the issuance of this order. The amendments concerning assignment also relieve a restriction on the ability of purchasers, once good faith negotiation has been initiated, to obtain renegotiation of all gas in multi-vintage contracts as of the issuance of this order regardless of subsequent assignments. The amendment concerning the upstream transportation authorization relieves a restriction on the ability of non-Order No. 436 interstate pipelines to continue upstream transportation of gas released under the good faith negotiation rule regardless of the Commission authority under which the prior transportation was performed, and the amendment concerning transportation by intrastate pipelines relieves a restriction on the ability of intrastate pipelines not desiring to become open access pipelines to transport released gas.

The information collection provisions in this rule are being submitted to the Office of Management and Budget (OMB) for its aproval under the Paperwork Reduction Act[38] and OMB's implementing regulations.[39] Interested persons can obtain information on these information collection provisions by contacting the Federal Energy Regulatory Commission, 825 North Capitol Street, NE., Washington, D.C. 20426 (Attention: Ellen Brown (202) 357-8272). Comments on the information collection provisions can be sent to the Office of Information and Regulatory Affairs of OMB, New Executive Office Building, Washington, D.C. 20503 (Attention: Desk Officer of the Federal Energy Regulatory Commission).

List of Subjects

18 CFR Part 270

Natural gas, Price controls, Reporting and recordkeeping requirements.

18 CFR Part 284

Continental shelf, Natural gas, Reporting and recordkeeping and requirements.

In consideration of the foregoing, the Commission is amending Parts 270 and 284, Title 18, Code of Federal Regulations as set forth below.

By the Commission.

Kenneth F. Plumb.

Secretary.

[38] 44 U.S.C. 3501-3520 (1982).

[39] 5 CFR 1320 (1986).